Supreme Court, U.S.
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In The
# Supreme Court of the United States

SAMUEL GLAZER,

*Petitioner,*

v.

LEHMAN BROTHERS, INC., *et al.*,

*Respondents.*

**On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Sixth Circuit**

## PETITION FOR A WRIT OF CERTIORARI

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## QUESTIONS PRESENTED

In *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*, 388 U.S. 395 (1967), the Supreme Court held that under the Federal Arbitration Act ("FAA"), a claim of fraudulent inducement of a contract containing an arbitration clause must be resolved by an arbitrator, but a claim of fraudulent inducement of the arbitration provision standing alone must be resolved by the court. This is known as the "separability" doctrine. The questions presented in this case address the scope and continued viability of the separability doctrine.

1. Must a court, and not an arbitrator, resolve *all* claims that the underlying contract is void from its inception? *Prima Paint* did not address this question, and the Sixth Circuit and three other federal appellate courts have held that a court's authority is limited to resolving only a few types of void *ab initio* claims, whereas five other federal appellate courts and many state high courts have held that *all* void *ab initio* claims must be resolved in court.

2. As a matter of federal substantive law under the FAA, does the *Prima Paint* defense of fraudulent inducement of the arbitration provision standing alone bar application of a state's common law parol evidence rule, when the parol evidence rule bars all realistic fraud claims directed at the arbitration provision standing alone?

3. Did the Sixth Circuit commit a gross error of law by selectively and inconsistently applying *Prima Paint*'s separability doctrine, by invoking separability to bar Glazer's claim that the entire contract was void *ab initio*, and then ignoring separability in order to use the underlying contract to bar his claim that the arbitration provision standing alone was a "sham agreement" under state law?

## PARTIES TO THE PROCEEDINGS

I. The parties to the proceedings in the first Sixth Circuit decision below, *Fazio et al. v. Lehman Bros., Inc.*, 340 F.3d 386 (6th Cir. 2003), reversing and remanding the District Court decision *Fazio et al. v. Lehman Bros., Inc.*, 268 F. Supp. 2d 865 (N.D. Ohio 2002), are listed below. Several cases were consolidated by the District Court for pretrial purposes, and both the District Court and Sixth Circuit issued a single opinion. The courts continued to use separate docket numbers for the cases, and separate judgments were entered.

- Case No. 1:02 CV 370 – Plaintiff, Samuel Glazer, and Defendants, Lehman Brothers, Inc., SG Cowen Securities Corporation, Lehman Brothers Holdings, Inc., and Societe Generale SA. (First Amended Complaint, Court of Appeals Appendix to first Sixth Circuit panel at 302.)

- Case No. 1:02 CV 157 – Plaintiffs, Robert Fazio, Carl Fazio, Sr., Irene Dugger Fazio, Fazio Investment One Limited, Fazio Investment Three Limited, and Defendants, Lehman Brothers, Inc., Lehman Brothers Holdings, Inc., SG Cowen Securities Corporation, Societe Generale SA, Cowen & Company, Hambrecht & Quist, Inc., and J.P. Morgan Chase & Co. (Second Amended Complaint, C.A. App. 151.)

- Case No. 1:02 CV 382 – Plaintiffs, Dominic A. Visconsi, Sr., Dominic A. Visconsi, Jr., James V. Stanton, and Defendants, Lehman Brothers, Inc., Lehman Brothers Holdings, Inc., SG Cowen Securities Corporation, Societe Generale SA, and Cowen & Company. (First Amended Complaint, C.A. App. 378.)

- Case No. 1:02 CV 761 – Plaintiffs, Peter A. Spitalieri, Peter A. Spitalieri Trustee, and Defendants, Lehman

**PARTIES TO THE PROCEEDINGS** – Continued

Brothers, Inc., Lehman Brothers Holdings, Inc., SG Cowen Securities Corporation and Societe Generale SA. (Complaint, C.A. App. 433.)

- Case No. 1:02 CV 764 – Plaintiffs, Richard Lopardo, Catherine Lopardo, Melissa Lopardo, Charles Lopardo, the Estate of Emily Lopardo, Charles Lopardo, Executor, James Lopardo, and Defendants, Lehman Brothers, Inc., SG Cowen Securities Corporation, Cowen & Company, Hambrecht & Quist, Inc., DeGrandis & DeGrandis, and J.P. Morgan Chase & Co. (Complaint, C.A. App. 474.)

- Case No. 1:02 CV 968 – Plaintiffs, Thomas J. Savoca, Dolores A. Savoca, and Defendants, SG Cowen Securities Corporation, Societe Generale SA, Cowen & Company, and Lehman Brothers, Inc. (Complaint, C.A. App. 515.)

- Case No. 1:02 CV 1018 – Plaintiff, Peter M. Bonutti, M.D., and Defendants, Lehman Brothers, Inc., SG Cowen Securities Corporation, Cowen & Company, and Joseph DeGrandis, Jr. d/b/a DeGrandis & DeGrandis. (Complaint, C.A. App. 935.)

II. The parties to the proceedings in the second Sixth Circuit decision below, *Glazer v. Lehman Bros., Inc.*, 394 F.3d 444 (6th Cir. 2005), reversing and remanding the District Court decision *Glazer v. Lehman Bros., Inc.*, No. 1:02 CV 370 (N.D. Ohio Oct. 3, 2003), were Plaintiff, Samuel Glazer, and Defendants, Lehman Brothers, Inc., SG Cowen Securities Corporation, Societe Generale SA, and Lehman Brothers Holdings, Inc. 394 F.3d at 444.

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## PETITION FOR A WRIT OF CERTIORARI

The Petitioner, Samuel Glazer ("Glazer"), respectfully submits this Petition for a Writ of Certiorari to review two judgments of the United States Court of Appeals for the Sixth Circuit in this matter.

## OPINIONS BELOW

The District Court denied the Respondents' motions to compel arbitration of Glazer's claims on July 19, 2002, in *Fazio et al. v. Lehman Bros., Inc.*, 268 F. Supp. 2d 865 (N.D. Ohio 2002). The Respondents appealed to the Sixth Circuit which entered a judgment on August 13, 2003, reversing and remanding the arbitration issue for further fact-finding on Glazer's claim that an arbitration provision was procured by fraud. *Fazio et al. v. Lehman Bros., Inc.*, 340 F.3d 386 (6th Cir. 2003). On October 3, 2003, after an evidentiary hearing, the District Court specifically found fraudulent inducement of the arbitration provision and again denied Respondents' motions to compel arbitration. *Glazer v. Lehman Bros., Inc.*, No. 1:02 CV 370 (N.D. Ohio Oct. 3, 2003). The Respondents appealed to the Sixth Circuit which entered a second judgment in this case on January 12, 2005, reversing and remanding the matter. *Glazer v. Lehman Bros., Inc.*, 394 F.3d 444 (6th Cir. 2005). Glazer seeks review of *both* Sixth Circuit panel decisions. *See infra* note 5.

## JURISDICTION

The judgments of the United States Court of Appeals for the Sixth Circuit were entered on August 13, 2003, and January 12, 2005. This Court has jurisdiction under 28 U.S.C. § 1254(1).

## CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Article III of the United States Constitution:

> The judges, both of the supreme and inferior courts, shall hold their offices during good behaviour, and shall, at stated times, receive for their services, a compensation, which shall not be diminished during their continuance in office. . . . The judicial power shall extend to all cases, in law and equity, arising under this Constitution, the laws of the United States . . . [and] to controversies . . . between citizens of different states. . . . U.S. Const. art. III, § 1, 2.

The Fifth Amendment to the U.S. Constitution:

> No person shall be . . . deprived of life, liberty, or property, without due process of law. . . . U.S. Const. amend. V.

The Seventh Amendment to the U.S. Constitution:

> In suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise reexamined in any court of the United States, than according to the rules of the common law. U.S. Const. amend. VII.

The Fourteenth Amendment to the U.S. Constitution:

> [N]or shall any state deprive any person of life, liberty, or property, without due process of law. . . . U.S. Const. amend XIV, § 1.

Section 2 of the Federal Arbitration Act ("FAA"), 9 U.S.C. § 2 (emphasis added):

> A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, *save upon such grounds as exist at law or in equity for the revocation of any contract.*

Section 3 of the FAA, 9 U.S.C. § 3:

> If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

Section 4 of the FAA, 9 U.S.C. § 4 (emphasis added):

> A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written

> agreement for arbitration may petition any United States district court which, save for such agreement, would have jurisdiction under Title 28, in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement. . . . *The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement.*

## STATEMENT OF THE CASE

This case presents the question of whether, under the Federal Arbitration Act ("FAA"), 9 U.S.C. § 2 *et seq.*, and this Court's opinion in *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*, 388 U.S. 395 (1967), a court must enforce an arbitration provision when the underlying contract in which it is contained is claimed to be void from its inception ("void" or "void *ab initio*").[1] *Prima Paint* left open this question regarding who should determine void *ab initio* claims. Arbitration is now widespread, and the federal courts of appeals are split on this frequently arising issue. The Sixth Circuit and three other federal

[1] A void contract "produces no legal obligation." Because it "does not come into existence . . . it cannot be a contract" at all. In contrast, a voidable contract "is an agreement that unless rescinded . . . imposes on parties the same obligations as if it were not voidable." *Sphere Drake Ins. Ltd. v. Clarendon Nat'l Ins. Co.*, 263 F.3d 26, 32 (2d Cir. 2001) (quotations omitted).

appellate courts require arbitration of all claims that the underlying contract is void except in a few very limited circumstances, such as forgery. In contrast, five other appellate courts and many state high courts require that a court resolve *all* claims that a contract is void from its inception, recognizing that if no contract exists, an arbitrator has no authority.

In this Petition, Glazer also asks the Court to breathe life into its 38-year-old opinion in *Prima Paint*. This Court held that under the FAA, an arbitration provision is severable from the underlying contract in which it appears, and a court may resolve a claim of fraud in the inducement only if the claim is directed specifically at the severed arbitration provision itself. This is called the "separability" or "severability" doctrine. In the current case, Glazer asserted a quintessential *Prima Paint* claim of fraudulent inducement of the arbitration provision standing alone. However, the Sixth Circuit invoked state parol evidence law to reject his claim. The court also rejected his claim that the arbitration provision itself was a sham agreement under state law by refusing to consider the arbitration provision standing alone, in violation of *Prima Paint*. In doing so, the Sixth Circuit effectively eliminated the *Prima Paint* defense as contemplated by this Court.

### A. Statement of Facts.

This Petition concerns arbitration, but the undisputed facts forming the basis of Glazer's claims on the merits are crucial to resolving Glazer's defenses to arbitration and the Sixth Circuit's errors below. Glazer's lawsuit against Respondents stems from probably the largest fraud ever

committed by a single securities broker in this country, involving numerous investors and hundreds of millions of dollars. The Petitioner, Samuel Glazer, lost millions because the Respondents wilfully and unlawfully turned a blind eye to an open and obvious criminal who was working for them. In mid-1998, Glazer met Frank Gruttadauria, who was a broker, Managing Director and Office Manager for the Respondent, SG Cowen Securities Corporation ("SG Cowen"). (Court of Appeals Appendix to second panel at 1316, 1356.)[2] Glazer did not know it, but Gruttadauria was actually a full-time criminal. For over 12 years, Gruttadauria had been using the brokerage's systems and policies to steal money and stock from customer accounts, to divert real account statements to post office boxes to hide his fraud, and to create fake, but very realistic, account statements for customers in order to hide his actions and to create the appearance of outstanding investment success. (Gruttadauria Aff. ¶ 4, Pet. App. 87, C.A. App. 1036; C.A. App. 141-42.)[3]

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[2] All Court of Appeals Appendix citations in the remainder of this Petition refer to the Joint Appendix submitted to the second panel of the Sixth Circuit below. The facts are also reflected in the appendix submitted to the first panel, although citations to that appendix are not included.

[3] Gruttadauria's criminal scheme and Respondents' related violations and fines are explained in the SEC's administrative orders to Respondents. Lehman Bros., Inc., Exchange Act Release No. 48336, 80 SEC Docket 2512-39 (Aug. 14, 2003) (fining Lehman $2.5 million for failing to supervise Gruttadauria), *available at* http://www.sec.gov/litigation/admin/34-48336.htm; SG Cowen Secs. Corp., Exchange Act Release No. 48335, 80 SEC Docket 2501-38 (Aug. 14, 2003) (fining SG Cowen $5 million for failing to supervise Gruttadauria), *available at* http://www.sec.gov/litigation/admin/34-48336.htm.

Gruttadauria was desperate when he met Glazer. Gruttadauria had been stealing from his customers for over 12 years, but he needed "new money" to satisfy customers' recent withdrawal demands. (Gruttadauria Aff. ¶ 5, 6, Pet. App. 87-88, C.A. App. 1036.) Glazer, who is now in his eighties, had the good financial fortune much earlier in life to have co-founded Mr. Coffee. Gruttadauria targeted him. Glazer told Gruttadauria, however, that he would not sign an account agreement containing an arbitration provision. (Gruttadauria Aff. ¶ 7, Pet. App. 88, C.A. 1036-37; C.A. App. 1359.) Glazer had refused to sign such agreements in the past, including with SG Cowen's predecessor Cowen & Company, and in one instance he won a court judgment. (C.A. App. 1033-34, 1038-66, 1304, 1307-10, 1354-56.) Gruttadauria told Glazer that his "title as Managing Director of SG Cowen was sufficient to assure him that SG Cowen would not enforce arbitration against him." (Gruttadauria Aff. ¶ 7, Pet. App. 88, C.A. App. 1036-37.) With this assurance, Glazer signed the account agreements, and Gruttadauria became his broker. (*Id.*; C.A. App. 1361-62, 1383-84, 1402-03.) Glazer then transferred millions in cash and stock to Gruttadauria and SG Cowen, which Gruttadauria immediately stole to continue his criminal enterprise. (Gruttadauria Aff. ¶ 9, Pet. App. 88, C.A. App. 1037.) No legitimate transaction was ever made for Glazer, and he never received any legitimate account statement showing the reality of his assets being stolen. (C.A. App. 178-204, 351-528.) The Respondents do not dispute these facts.

Respondent Lehman Brothers, Inc. ("Lehman") purchased SG Cowen's brokerage business in October of 2000 and paid Gruttadauria $5 million to stay on as its broker and branch manager. (C.A. App. 136-37.) Lehman

ignored its own policies and procedures, allowing Gruttadauria's fraud to continue. Gruttadauria's scheme finally collapsed and he disappeared at the beginning of January 2002, leaving a letter for the FBI: "I can hardly believe that I could have done this without detection for so long, the various firms [sic] greed and lack of attention at a senior level contributed greatly to that." (Gruttadauria Letter, Pet. App. 90.) It is now estimated that over a 15-year period Gruttadauria stole between $115-$150 million of capital from his customers and created an additional $275-300 million of fictional net worth in fake account statements. *See* SEC administrative orders, *supra* note 3; Susanne Craig, *Critics Lash Out at Wall Street Over Broker Acts*, The Wall Street Journal, May 24, 2002, at C1. Glazer was told by Lehman that instead of the $24 million he thought was in an account, there was only about $15,000. (C.A. App. 129-30, 139, 142-43.)

### B. Proceedings Below.

Glazer sued Respondents in federal court on February 28, 2002, asserting several claims including statutory securities fraud, common law fraud, breach of fiduciary duty, and estoppel.[4] Jurisdiction was invoked under 28 U.S.C. § 1331 based on Glazer's claims under Sections 10(b) and 20(a) of the Securities and Exchange Act, 15 U.S.C. §§ 78(j)(b), 78(t)(a). Jurisdiction was also invoked

[4] Many other investors who lost money throughout the course of Frank Gruttadauria's scheme also sued. Cases filed in the Northern District of Ohio were transferred to the same judge in that court and were consolidated for pretrial purposes. The District Court, however, issued a single opinion for all plaintiffs but entered a separate judgment for each case. All of the parties to these cases are listed in the Parties to the Proceedings section of this Petition, *supra*.

under 28 U.S.C. § 1332 because Glazer is a citizen of Florida; SG Cowen is a New York company with its principle place of business in New York; Lehman Brothers, Inc. and Lehman Brothers Holdings, Inc. are Delaware companies with their principle places of business in New York; and Societe Generale SA is a French company with its principle place of business in the United States in New York.

SG Cowen and Lehman filed motions to compel arbitration based on the same account documents that Gruttadauria desperately convinced Glazer to sign with his adamant assurance that arbitration would not be enforced. Glazer opposed the motions on two grounds. First, the entire account agreement was void from its inception because Gruttadauria's criminal purpose barred the formation of a contract based on ordinary principles of state contract law. Second, the arbitration provision standing alone was fraudulently induced by Gruttadauria's assurance of non-enforcement that he made in furtherance of his crime. In *Fazio et al. v. Lehman Bros., Inc.*, 268 F. Supp. 2d 865 (N.D. Ohio 2002), Pet. App. 71, the District Court denied the motions to compel. The District Court held that under the FAA and the Supreme Court's decision in *Prima Paint*, it was authorized to determine whether the underlying account agreement came into existence. The District Court ruled that because Gruttadauria never intended to act as a broker, but instead intended only to steal, "the intentions of the parties differed drastically," and "there was never any meeting of the minds, both to the contract as a whole, *and as to the arbitration clause specifically*." *Id.* at 78 (emphasis in original). The court did not rule on Glazer's claim

that Gruttadauria made a fraudulent representation specifically about the arbitration provision.

Respondents appealed, and in *Fazio et al. v. Lehman Bros., Inc.*, 340 F.3d 386 (6th Cir. 2003), Pet. App. 31, the Sixth Circuit reversed and remanded. The court held that the District Court's authority was limited only to claims targeting the arbitration provision specifically or to claims of forgery and signatory power. *Id.* at 47-48. The court ignored Glazer's request that it address the legal effect of Gruttadauria's fraudulent assurance that arbitration would not be enforced.[5]

On remand of Glazer's claim targeting the arbitration provision itself, and following an evidentiary hearing, the District Court found fraud based on Gruttadauria's assurance, and again denied the motions to compel. It held that the arbitration provision should be analyzed as a standalone agreement and, based on this separability, it enforced the parties' true agreement that there would be no arbitration. *Glazer v. Lehman Bros., Inc.*, No. 1:02 CV 370 (N.D. Ohio Oct. 3, 2003), Pet. App. 49.

Respondents initiated a second appeal, and the Sixth Circuit again reversed the District Court. *Glazer v. Lehman Bros., Inc.*, 394 F.3d 444 (6th Cir. 2005), Pet. App. 1.

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[5] The first Sixth Circuit panel decision in this case is ripe for review at this time because Glazer had to wait for resolution of the remand issue in order to avoid piecemeal petitions to this Court. *See Nat'l Credit Union Admin. v. First Nat'l Bank & Trust Co.*, 522 U.S. 479 (1998) (After resolving a standing issue, the court of appeals remanded for further proceedings that resulted in another appeal, and both standing and the remand issues were addressed by the Supreme Court.); *compare Virginia Military Inst. v. U.S.*, 508 U.S. 946 (1993) (denying certiorari and stating that review could be granted after remanded issues were resolved).

The Sixth Circuit held that Ohio's parol evidence rule barred evidence of Gruttadauria's assurance of non-enforcement because these statements conflicted with the arbitration provision. *Id.* at 17-27. The court also refused to apply Ohio's "sham agreement" doctrine, under which parol evidence may be presented to show that the parties did not intend or understand an apparent agreement to be binding. *Id.* at 12-27. The doctrine generally applies to entire contracts and not to provisions within a broader contract. The court affirmatively invoked the entire brokerage agreement and held that the arbitration agreement was a mere provision that could not be a sham agreement. The Sixth Circuit ignored separability and refused to consider the arbitration provision standing alone as required by *Prima Paint*. The court used state law to effectively eliminate Glazer's claims targeting the arbitration provision specifically, and it ordered arbitration. In this Petition, Glazer asks this Court to resolve a question left open in *Prima Paint* and hold that a court must determine *all* void *ab initio* claims. Glazer also asks this Court to hold that state law cannot be used to nullify the very fraud in the inducement defense validated by this Court in *Prima Paint*.

## REASONS FOR GRANTING WRIT

### I. FEDERAL AND STATE COURTS ARE DEEPLY DIVIDED OVER WHETHER, UNDER THE FEDERAL ARBITRATION ACT, A COURT MUST RESOLVE ALL CLAIMS THAT A CONTRACT IS VOID FROM ITS INCEPTION.

This Petition for a Writ of Certiorari should be granted because the federal courts of appeals are divided

over the extent to which a court has the authority to determine whether a contract containing an arbitration provision is void.[6] In *Prima Paint*, this Court addressed the specific issue of whether a court or an arbitrator must determine that an underlying contract was fraudulently induced. An arbitration provision was contained within a consulting agreement. When a dispute arose, one party to the agreement claimed that it had been fraudulently induced to sign because the other party misrepresented its financial solvency. 388 U.S. at 396-98. Such a claim would render the consulting contract voidable. *Id.* at 399 n.3. This Court held that under the FAA, an arbitration provision contained in a broader underlying contract is deemed severable from that broader contract, and that a court can adjudicate only a claim of fraud in the inducement of the arbitration clause itself. In contrast, a claim of fraudulent inducement of the underlying contract must be resolved by the arbitrator. *Id.* at 404. Because the financial solvency argument in *Prima Paint* attacked the validity of the contract as a whole, this Court held that the claim must be arbitrated. *Id.* at 406.

*Prima Paint* involved a claim that the underlying contract was voidable at the election of a party, and it offered no guidance regarding claims other than fraudulent inducement. Since *Prima Paint* was decided in 1967, courts have struggled with the issue of whether other defenses to arbitration should be determined by a court or an arbitrator. The result is a persistent and clear split among the appellate courts over the extension

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[6] In the language of Section 4 of the FAA, the question is whether a challenge to the existence of the underlying contract places the "making of the agreement for arbitration" at issue.

of *Prima Paint* to claims that the underlying contract was void from its inception. Four circuits, including the Sixth Circuit, invoke *Prima Paint* to require arbitration of all claims that the underlying contract is void, except in extremely narrow circumstances. Five other appellate courts and many state high courts recognize that an arbitrator has authority only if a valid underlying contract first exists. These courts properly refuse to send to arbitration *all* claims that the broader underlying contract was void from inception because such claims allege that no contract came into existence. These courts send to arbitration claims that an underlying contract is voidable (and therefore may be avoided at the election of a party) because a valid contract came into existence. This Court should reverse the Sixth Circuit with a direction that the latter, majority view of the FAA is properly the law, and a court must adjudicate *all* void *ab initio* claims targeting the underlying contract.

Resolving this split is important. Since *Prima Paint*, mandatory arbitration has become widespread,[7] and today, its very legitimacy in the securities industry is under attack for failing to protect investors' rights. *See, e.g.*, Susanne Craig, *Rough Justice: Wall Street Panels for Settling Fights Draw Renewed Fire*, Wall Street Journal,

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[7] The National Association of Securities Dealers reportedly handled 8,945 arbitrations in 2003, an increase of 14% from 2002. *See* Gary Weiss, *Are Investors Walled Off From Justice?*, BusinessWeek online, March 22, 2004, *at* http://BusinessWeek.com. The American Arbitration Association administered over 218,000 cases in 2001 and over 230,000 cases in 2002. Am. Arbitration Ass'n, 2001 President's Letter and Financial Statements 2 (2002) (noting seven consecutive years of growth), *available at* http://www.adr.org/si.asp?id=1746; About Us, A Brief Overview of the American Arbitration Association, *at* http://www.adr.org/Overview.

March 17, 2005, at A1, Pet. App. 92. This criticism highlights the importance of voluntary consent to arbitration and of judicial determination that a contract is void *ab initio*. A significant number of courts are sending claims to arbitration in cases where the underlying contract never existed in the first place. Such action is contrary to the FAA, contrary to this Court's holdings that arbitration is exclusively a creature of contract, and violative of the United States Constitution as parties are denied their rights to a judicial forum, a jury trial, and due process. The Supreme Court should grant this Petition and resolve the split among the appellate courts by holding that all void *ab initio* claims must be resolved by a court.

### A. The Sixth Circuit and three other circuits improperly send void *ab initio* claims to arbitration.

The split in the federal courts of appeals regarding the application of *Prima Paint* to claims that a contract is void was recognized by the Sixth Circuit four years ago in *Burden v. Check Into Cash*:

> Several of our sister circuit courts have found that *Prima Paint* does not apply to allegations of nonexistent contracts. . . . The Third Circuit and Ninth Circuit respectively, have expressly found that *Prima Paint* applies to voidable, but not void, contracts. . . . In contrast, the Fifth Circuit has found that *Prima Paint* applies even to contracts that are void from . . . inception.

267 F.3d 483, 488 (2001) (citations omitted), *cert. denied*, 535 U.S. 970 (2002). In addressing this split, the Sixth Circuit acknowledged that a void contract is never a contract at all and that straightforward logic requires that

a valid arbitration agreement cannot be formed within a void contract. The court further acknowledged the logical distinction between claims that an underlying contract is voidable (like the fraudulent inducement claim in *Prima Paint*) and claims that the contract is void from inception. Nevertheless, the Sixth Circuit expressly rejected this logic and held that under *Prima Paint* all claims targeting the underlying contract (void and voidable) must be sent to arbitration, except for the narrow issues of forgery or signatory power. *Id.* at 488-90.

The injustice of the Sixth Circuit's view of *Prima Paint* is underscored by the facts in *Burden*. The plaintiffs in *Burden* received loans based on their promise to deliver future paychecks. The check cashing operation charged annual percentage rates in excess of 500%. *Id.* at 486. The plaintiffs claimed the loan agreements were void under state lender licensing laws and for charging usurious interest rates. Without denying that the contracts were obviously void under state law, the Sixth Circuit nonetheless sent the claims to arbitration. *Id.* at 490. The court has improperly sent many such claims to arbitration, even extending *Prima Paint* to a clear claim of voidness under a federal statute. *See CBS Employees Federal Credit Union v. Donaldson, Lufkin and Jenrette Secs. Corp.*, 912 F.2d 1563, 1564-65 (6th Cir. 1990) (holding that an arbitrator must determine whether a securities agreement containing an arbitration provision was procured by fraud in the factum, where defendants allegedly misrepresented the nature of the collateral required by the agreement, even though such a fraud defense would render the contract void); *Match-E-Be-Nash-She-Wish Band of Pottawatomi Indians v. Kean-Agrovitz Resorts*, 383 F.3d 512 (2004), *rehearing en banc denied*, No. 03-1267, 2004 U.S.

App. LEXIS 24581 (6th Cir., Nov. 18, 2004) (holding that an arbitrator must determine whether a casino development agreement was void because it was not approved by the Chairman of the National Indian Gaming Commission as required by federal statute, despite the court's admission that the contract was obviously void). A dissent in the *Pottawatomi Indians* case implored the Sixth Circuit to reconsider its treatment of void *ab initio* claims, to no avail as a request for rehearing *en banc* was recently denied. 383 F.3d at 518-21 (Cleland, J., dissenting).

The Sixth Circuit continued its misapplication of *Prima Paint* in its treatment of Glazer's claim in the current case. Glazer claims that the underlying customer account agreement containing the arbitration provision never came into existence based on fundamental principles of state law.[8] The District Court found that Gruttadauria's criminal intent and lack of intent to perform as a broker precluded the existence of a contract under state law. The Sixth Circuit reversed, holding that because the claim was not directed at the arbitration provision standing alone, an

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[8] Under Ohio law, the essential elements of a contract include offer, acceptance, contractual capacity, consideration, and manifestation of mutual assent. *Perlmuter Printing Co. v. Strome, Inc.*, 436 F. Supp. 409 (N.D. Ohio 1976). "In order for a contract to be formed, there must be a meeting of the minds of the parties concerning a *lawful subject matter*, as well as an actual agreement to do or forbear from doing a specific thing." 17 Ohio Jur. 3d, *Contracts* § 7 (West 2001) (emphasis added). Gruttadauria's admitted criminal mentality and purpose precluded any meeting of the minds, capacity to contract, mutual assent, mutuality, and consideration. *See, e.g.*, Laurence P. Simpson, *Simpson on Contracts*, § 37 (1st ed., West 1954) ("Void promises, like illusory promises, are wholly without legal value or the possibility of legal value, so they cannot furnish consideration for the counter promise and the entire agreement fails for want of mutuality of obligation.").

arbitrator had to decide whether the underlying contract came into existence. In five other federal appellate courts, Glazer's claim would have remained in court.

The Fourth, Fifth, and Eleventh Circuits follow the Sixth Circuit's narrow view of *Prima Paint*. The Fourth Circuit's case of *Snowden v. Checkpoint Check Cashing*, 290 F.3d 631 (4th Cir.), *cert. denied*, 537 U.S. 1087 (2002), also involved a check-cashing operation, usurious interest rates, and the lack of state-required licenses. The court agreed with the Sixth Circuit's *Burden* decision and announced that judicial review is limited to claims involving authority or signatory problems. *Id.* at 637; *see also Will Drill Res., Inc. v. Samson Res. Co.*, 352 F.3d 211, 215 n.15 (5th Cir. 2001) (rejecting the void-voidable distinction recognized by the Second and Third Circuits); *Jenkins v. First Am. Cash Advance*, 400 F.3d 868, 882 n.12 (11th Cir. 2005) (following the Fourth and Sixth's Circuits approach to void *ab initio* claims under usury laws, and distinguishing cases in which assent to the contract is at issue, such as whether a non-signatory is bound). In sum, four federal appellate courts give authority to arbitrators to resolve most claims that a contract never existed in the first place, which is an interpretation of the FAA that has been rejected by five other federal appellate courts and many state high courts.

The views of the Sixth, Fourth, Fifth, and Eleventh Circuits defy this Court's repeated admonitions that arbitration is a creature of contract and that parties cannot be forced to arbitrate unless they have agreed to do so. *EEOC v. Waffle House, Inc.*, 534 U.S. 279, 293-94 (2002) (quoting *Volt Info. Sciences, Inc. v. Bd. of Trustees of Leland Stanford Jr. Univ.*, 489 U.S. 468, 478 (1989)); *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 219-20 (1985).

Requiring an arbitrator to determine a dispute when it is claimed that no underlying contract existed flies in the face of this principle. Also, by forcing a party to arbitrate when no contract came into existence, a court denies that party its constitutional rights to a judicial forum, a jury trial, and due process. *See Prima Paint*, 388 U.S. at 407 (Black, J., dissenting, Stewart, J., Douglas, J., joining) (stating that "forcing a person to forgo his opportunity to try his legal issues in the courts where, unlike the situation in arbitration, he may have a jury trial and right to appeal" and having "nonlawyers ... decide the legal question of whether any legal contract exists upon which to base an arbitration" may be a "denial of due process" and may "trespass upon the court's prerogative"); *Ortiz v. Fibreboard Corp.*, 527 U.S. 815 (1999) (discussing the due process and jury trial rights of absent plaintiffs in a class action); *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989) (recognizing limits to Congress's ability to abridge Article III and Seventh Amendment rights); *Logan v. Zimmerman Brush Co.*, 455 U.S. 422, 429 (1982) (stating that "the Due Process clauses protect civil litigants who seek recourse in the courts").

This Court has dictated that arbitration provisions should not be given special treatment and that states are free to establish applicable contract law. The FAA was designed simply to place arbitration agreements "upon the same footing" as other contracts. By refusing to allow judicial review of void *ab initio* claims, the Sixth Circuit and other appellate courts ignore states' rights to determine the types of contracts that may come into existence, and these courts improperly place arbitration provisions on a preferred footing above legitimate state law. *See Doctor's Associates, Inc. v. Casarotto*, 517 U.S. 681, 687

(1996); *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 281 (1995). Therefore, Glazer requests that his Petition be granted to resolve a deep and clear split among appellate courts, and that the Sixth Circuit's decisions below be reversed and remanded.

### B. Five federal circuits and many state high courts properly refuse to require arbitration of claims that a contract is void from inception.

Five federal courts of appeals and many state high courts mandate that all claims that a contract is void *ab initio* must be resolved in court, and not arbitration. The leading case is *Sandvik AB v. Advent International Corp.*, 220 F.3d 99, 107-09 (3d Cir. 2000). The Third Circuit defined a clear, bright-line rule by which *Prima Paint* only sends to arbitration claims that a contract is voidable. In contrast, *all* claims that a contract is void are reserved for the court:

> Mindful of the doctrine announced in *Prima Paint*, which did not consider a situation in which the *existence* of the underlying contract was in issue, we draw a distinction between contracts that are asserted to be "void" or nonexistent, as is contended here, and those that are merely "voidable," as was the contract at issue in *Prima Paint*, for purposes of evaluating whether the making of an arbitration agreement is at issue.

The Third Circuit aptly explained the reasoning behind this distinction:

> Allowing the District Court to pass on the question whether the arbitration agreement is valid

> . . . comports with contract law principles. . . . [A]rbitration is a matter of contract, and no arbitration may be compelled in the absence of an agreement to arbitrate . . . Therefore, there does not appear to be any independent source of validity of the arbitration clause once the underlying contract is taken off the table.

*Id.* at 108 (holding that the District Court was correct to determine whether an underlying agreement existed before it sent the parties to arbitration, and emphasizing that claims that a signatory acted without power would render the contract void); *see also China Minmetals Materials Import & Export Co. v. Chi Mei Corp.*, 334 F.3d 274, 282 (3d Cir. 2003) (re-affirming that straightforward contract law requires courts to resolve all void *ab initio* claims); *Par-Knit Mills, Inc. v. Stockbridge Fabrics Co.*, 636 F.2d 51, 54-55 (3d Cir. 1980) (holding that a claim that there was no meeting of the minds on the terms of the underlying contract was to be resolved by the court because no agreement to arbitrate would have been formed).

Another widely cited case is the Ninth Circuit's opinion in *Three Valleys Municipal Water District v. E.F. Hutton & Co.*, 925 F.2d 1136 (9th Cir. 1991). In *Three Valleys*, the court held that *Prima Paint* is broadly "limited to challenges seeking to *avoid* or *rescind* a contract – not to challenges going to the very existence of a contract that a party claims never to have agreed to." *Id.* at 1140. Under *Prima Paint*, "an arbitrator may properly decide 'voidable' contracts because the parties have agreed to arbitrate the dispute." *Id.* In contrast, an arbitrator is without authority to consider a contract claimed to be void because an "arbitrator's jurisdiction is rooted in the agreement of the parties." *Id.* (quotations omitted) (emphasizing that a

court must resolve all void *ab initio* claims, and holding that the District Court erred by sending a claim regarding signatory power to arbitration); *see also Large v. Conseco Fin. Servicing Corp.*, 292 F.3d 49, 53 (1st Cir. 2002) (adopting the void-voidable distinction and sending claims to arbitration because the federal lending law in question only rendered the contract voidable, as opposed to providing for automatic rescission or voidness); *Sphere Drake Ins. Ltd. v. Clarendon Nat'l Ins. Co.*, 263 F.3d 26, 30-32 (2d Cir. 2001) (explaining the void-voidable distinction and holding that because they would render the underlying contract void, claims that a signatory acted without authority were for the court); *Sphere Drake Ins. Ltd. v. All Am. Ins. Co.*, 256 F.3d 587, 591 (7th Cir. 2001) (following the Third and Ninth Circuits and summarizing the rule most succinctly: "No contract, no power," and holding that an issue of signatory power was for the court); *Interocean Shipping Co. v. Nat'l Shipping & Trading Co.*, 462 F.2d 673, 676-77 (2d Cir. 1972) (holding that a claim that there was no meeting of the minds on the terms of the underlying contract was to be resolved by the court because no contract would have existed).

The state high courts that have recently considered this question also distinguish between void and voidable claims when applying the FAA, rejecting the narrow view held by the Sixth, Fourth, Fifth and Eleventh Circuits. For example, the Alabama and Florida Supreme Courts, which are in the Eleventh Circuit, reject that Circuit's narrow view of *Prima Paint*. In *Mason v. Acceptance Loan Co.*, 850 So. 2d 289, 295 n.2 (Ala. 2002), the Supreme Court of Alabama instead "follow[ed] the reasoning of other courts that limit the holding in *Prima Paint* to 'voidable' contracts." It held that whether a party lacked capacity

because of mental retardation was properly addressed by the court, and not an arbitrator, because state law made the underlying contract void. In *Cardegna v. Buckeye Check Cashing, Inc.*, ___ So. 2d ___, 30 Fla. L. Weekly S 29, 2005 WL 106966 (Fla. Jan. 20, 2005), the Florida Supreme Court expressly rejected the approach of the Eleventh Circuit and held that a claim of voidness under state usury laws was for the court to determine. *See also Nature's 10 Jewelers v. Gunderson*, 2002 S.D. 80, ¶ 13 (2001), 648 N.W.2d 804, 807 (holding that claims that a franchise agreement was void under state law was for a court, and additionally stating that *"[t]his Court will not permit the individuals who committed the illegal acts on behalf of the corporation to benefit from the arbitration clause in the illegal contract"* (emphasis added)); *Rosenthal v. Great W. Fin. Secs. Co.*, 14 Cal. 4th 394, 416-17, 926 P.2d 1061, 1074 (1996) (holding that *Prima Paint* does not apply to claims that the broader contract is void because of fraud in the execution because "the parties have not agreed to arbitrate any controversy," but claims that a contract is voidable because of fraud in the inducement are subject to arbitration); *Jensen v. Quik Int'l*, 213 Ill. 2d 119, 125-29, 820 N.E.2d 462, 466-67 (2004) (holding that claims under state franchise law should be determined by an arbitrator because the law only renders contracts voidable and does not create a condition precedent, and "[h]ad the legislature intended that a franchise agreement entered into in violation of [state statute] be unenforceable, it could have easily so provided"); *Iowa Mgmt. & Consultants, Inc. v. Sac & Fox Tribe*, 656 N.W.2d 167, 171 n.1 (Iowa 2003) (holding that if a management consulting contract was void under federal law, the arbitration provision contained within it was void as well); *Onvoy, Inc. v. SHAL, LLC*, 669 N.W.2d 344, 352-56 (Minn. 2003)

(holding that whether a corporate contract was void under state law because of the participation of an interested director was for the court, but that *Prima Paint* would apply if the contract were claimed to be only voidable); *Pittsfield Weaving Co. v. Grove Textiles, Inc.*, 121 N.H. 344, 430 A.2d 638 (1981) (holding that whether the underlying contract was unconscionable was an issue for the court, where this would render the contract void under state law); *Fox v. Tanner*, 2004 W.Y. 157, 101 P.3d 939, 944, 949-50 (Wyo. 2004) ("There is little logic in deciding that an arbitrator should decide a matter and then have him determine that the contract by which he is vested with this authority is void," where under state law, "fraud will vitiate a contract").

Therefore, Glazer requests that his Petition be granted to resolve this split and reverse the Sixth Circuit decision below, which ignores the holdings of this Court, the rights of parties under the Constitution and contract law, and states' rights to govern contracts. This Court should adopt the majority rule, which respects these rights by refusing to send *all* void *ab initio* claims to arbitration.

## II. THE SIXTH CIRCUIT USED STATE COMMON LAW TO EFFECTIVELY NULLIFY *PRIMA PAINT* BY PRECLUDING ALL FRAUD CLAIMS TARGETING THE ARBITRATION PROVISION DIRECTLY.

After ruling that Glazer's void *ab initio* claim must be arbitrated, the Sixth Circuit remanded Glazer's claim of fraud targeting the arbitration provision itself. Glazer already had asserted this claim, but the District Court and the Sixth Circuit failed to rule on it. On remand, the District Court held an evidentiary hearing and found

fraud. In reversing this finding, the Sixth Circuit foreclosed any realistic fraudulent inducement claim challenging arbitration under *Prima Paint*, and it actually refused to apply *Prima Paint*'s separability doctrine. If *Prima Paint* has any meaning, the Sixth Circuit's second panel decision cannot stand.

### A. The Sixth Circuit used state common law to render *Prima Paint* a nullity while ignoring its precedent on fraudulent inducement of an arbitration provision.

It is undisputed that to continue his criminal enterprise by obtaining Glazer's assets, Gruttadauria expressly promised Glazer that SG Cowen would not enforce arbitration. The District Court considered this evidence and concluded that Glazer was fraudulently induced to agree to the arbitration provision standing alone. The Sixth Circuit reversed again and held that Gruttadauria's undisputed promise was barred by a common law parol evidence rule because the promise contradicted the written arbitration agreement. Pet. App. 17-27.

The Sixth Circuit's ruling effectively precludes any realistic opportunity for a party to avail itself of the fraudulent inducement defense authorized by *Prima Paint*. Any real-world fraud targeting an arbitration provision will always involve a misrepresentation that contradicts the written arbitration provision. *See, e.g., Great Earth Cos., Inc. v. Simons*, 288 F.3d 878 (6th Cir. 2002) (enforcing a fraudulent promise even though it

contradicted the arbitration provision);[9] *Benoay v. E.F. Hutton & Co.*, 699 F. Supp. 1523, 1529 (S.D. Fla.1988) (stating that the broker told his customer that signing the arbitration agreement was only a "mere formality" necessary to open the account). The Respondents have failed to identify any realistic type of fraudulent inducement of arbitration that would not be contradictory to the arbitration provision and thus could be adjudicated under *Prima Paint*. They have instead identified trivial, collateral frauds, such as misrepresentations about success rates in arbitration or the scope of discovery in arbitration. (S.G. Cowen's Final Brief to second panel at 48.) Such trivial, unrealistic "frauds" cannot possibly be what this Court had in mind when issuing its *Prima Paint* decision because in the real world such peripheral discussions about arbitration simply never occur.

The fact is that the Respondents have not, and likely cannot, point to any successful claim of fraudulent inducement of an arbitration provision in 38 years since *Prima Paint*. The Sixth Circuit's *Great Earth* decision might be the only one.[10] In *Great Earth*, the Sixth Circuit

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[9] The Sixth Circuit's decision followed a District Court opinion from the Southern District of New York, which the Sixth Circuit discussed, adopted, and endorsed in its opinion. *See Great Earth Cos., Inc. v. Simons*, No. 00 Civ. 0967, 2000 WL 310354 (S.D.N.Y. March 24, 2000), *withdrawn in part*, 2000 WL 640829 (S.D.N.Y. May 18, 2000). The District Court maintained its ruling that the requirement of arbitration in New York was fraudulently induced, but decided not to order arbitration in Michigan because it was not technically asked by the parties to issue such an order.

[10] Critics of the doctrine of separability have observed that claims of fraudulent inducement of an arbitration provision standing alone are rare because, even when fraud is targeted at the arbitration provision, it is usually so "disentangled" with fraud involving the underlying contract that courts send the claim to arbitration. Richard C. Reuben,

(Continued on following page)

enforced a fraudulent promise regarding the location of arbitration that directly contradicted the terms of the written arbitration provision, but the court did not mention any parol evidence bar. 288 F.3d at 890; *see Great Earth*, 2000 WL 310354, at *5-6. Successful claims of fraudulent inducement of an arbitration provision are at best very rare, with *Great Earth* possibly the only one, and the Sixth Circuit below failed to acknowledge this one recent instance in which it upheld the defense. Instead, it completely ignored *Great Earth* and applied the parol evidence rule in a manner that would preclude even the facts in *Great Earth*. It is extraordinarily important that the Sixth Circuit be prohibited from using state law to completely foreclose this already rare defense if *Prima Paint* is to have any meaning at all.

Glazer requests that this Court breathe life into the defense of fraudulent inducement of an arbitration provision and reverse the Sixth Circuit. In doing so, this Court should rule that because the decision in *Prima Paint* established a defense under federal substantive law, a common law parol evidence rule must give way to it. 388 U.S. at 404-05. Under *Prima Paint*, a court should be authorized to adjudicate a fraudulent promise that there will be no arbitration when that promise undisputedly induced the signing of the arbitration agreement itself, even though this promise also contradicts the writing.

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*First Options, Consent to Arbitration, and the Demise of Separability*, 56 SMU L. Rev. 819, 847, 879-80 (2003).

### B. The Sixth Circuit selectively and inconsistently applied *Prima Paint*'s separability doctrine, invoking the doctrine to prevent claims against the underlying contract, but ignoring the doctrine to prevent a claim against the arbitration provision.

In addition to rendering the *Prima Paint* defense a nullity and ignoring its own precedent, the Sixth Circuit performed one last trick of legal and logical magic in sending Glazer's void *ab initio* and fraud claims to arbitration: It made *Prima Paint* disappear. It performed this feat in order to avoid the "sham agreement" doctrine under Ohio law. This Court should grant the Petition and rule that *Prima Paint*'s requirement that the underlying contract be treated as a stand-alone agreement applies to any party's attempt to use the underlying contract, either to set aside or enforce the arbitration provision.

In Ohio, the "sham agreement" doctrine establishes an exception to the parol evidence rule. This doctrine provides that no contract exists, even though the parties sign it and it otherwise appears on its face to be a valid contract, if the parties agree at the time they sign that they are doing so purely as a "sham" and that their true agreement is something different. *Nat'l City Bank, Akron v. Donaldson*, 95 Ohio App.3d 241, 245, 642 N.E.2d 58, 60-61 (9th Dist. 1994). Under this doctrine, Gruttadauria's and Glazer's undisputed, admitted, and intended agreement that there would be no arbitration is valid under Ohio law, and the written arbitration agreement must be set aside.

The Sixth Circuit avoided this result by ignoring *Prima Paint*'s separability doctrine. The only way the Sixth Circuit could deny Glazer's claim was to invoke the rule that the sham agreement doctrine applies to whole

contracts and not to discrete provisions of a contract. Therefore, the court held that the arbitration provision was not a stand-alone agreement for purposes of the sham agreement doctrine. Pet. App. 12-27. This view is contrary to this Court's holding in *Prima Paint* that according to substantive federal law, an arbitration provision is analyzed as a severable stand-alone agreement. 388 U.S. at 404-05. The Sixth Circuit clearly manipulated the separability doctrine to foreclose *any* defense to arbitration: The Sixth Circuit invoked *Prima Paint*'s separability doctrine to bar Glazer's void *ab initio* claim in the first appeal, thus compelling arbitration, but the court refused to invoke *Prima Paint* in the second appeal, thus barring a fraud claim against the arbitration provision itself and again compelling arbitration. This *Prima Paint* disappearing act from one decision to another in the same case leaves the distinct impression that the court had only one goal: compel arbitration.

Petitioner implores this Court to intervene. Otherwise, the Respondents will succeed in benefitting from Gruttadauria's crime, and they will benefit from their own unlawful and wilful blindness to Gruttadauria's 15-year fraud. Petitioner therefore respectfully requests this Court's intervention by granting this Petition and reversing the decisions of the Sixth Circuit.

## CONCLUSION

This Petition for a Writ of Certiorari should be granted to resolve the Questions Presented. Great confusion has arisen since *Prima Paint* regarding void *ab initio* claims, and this Court should hold that only courts may

determine whether a contract containing an arbitration provision is void from its inception. This Court should also reaffirm the validity of the defense reserved for the courts in *Prima Paint* and hold that state law cannot be used to nullify claims that an arbitration provision itself was fraudulently induced.

Respectfully submitted,

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No. 03-4312, SAMUEL GLAZER, Plaintiff-Appellee, v. LEHMAN BROTHERS, INC., Defendant SG COWEN SECURITIES CORPORATION; SOCIETE GENERALE, Defendants-Appellants. No. 03-4415, SAMUEL GLAZER, Plaintiff-Appellee, v. LEHMAN BROTHERS, INC.; LEHMAN BROTHERS HOLDINGS, INC., Defendants-Appellants, SG COWEN SECURITIES CORPORATION, Defendant.

Nos. 03-4312/4415

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

394 F.3d 444; 2005 U.S. App. LEXIS 468; 2005 FED App. 0016P (6th Cir.)

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**COUNSEL:** ARGUED: P. Benjamin Duke, Covington & Burling, New York, New York, H. Nicholas Berberian, Neal, Gerber & Eisenberg, Chicago, Illinois, for Appellants. Robert P. Duvin, Duvin, Cahn & Hutton, Cleveland, Ohio, for Appellee.

ON BRIEF: P. Benjamin Duke, Laurence A. Silverman, Aaron R. Marcu, Covington & Burling, New York, New York, H. Nicholas Berberian, Neal, Gerber & Eisenberg, Chicago, Illinois, Douglas V. Bartman, Kahn Kleinman, Cleveland, Ohio, Mark O'Neill, Weston, Hurd, Fallon, Paisley & Howley, Cleveland, Ohio, for Appellants.

Robert P. Duvin, Kenneth D. Schwartz, Duvin, Cahn & Hutton, Cleveland, Ohio, for Appellee.

**JUDGES:** Before: DAUGHTREY and SUTTON, Circuit Judges; FORESTER, Chief District Judge.*

**OPINION BY:** KARL FORESTER.

**OPINION:**

KARL FORESTER, Chief District Judge. The Defendants-Appellants appeal the District Court's denial of their motion to compel arbitration. The District Court held that the arbitration provisions contained in five agreements between the Plaintiff-Appellee and the Defendants-Appellants were not enforceable because four of those provisions were fraudulently induced, based on oral representations made by a broker who worked for Appellants, and because a fifth agreement was superseded by subsequent criminal conduct and the other four agreements. We AFFIRM, in part, REVERSE, in part, and REMAND for further proceedings consistent with this opinion.

OVERVIEW

This appeal asks this Court to again review the Supreme Court's decision in *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 402-04, 18 L. Ed. 2d 1270, 87 S. Ct. 1801 (1967), and to construe the breadth of the Supreme Court's holding therein. Specifically, this appeal requires the Court to examine two areas of law, the "severability" of arbitration provisions under *Prima Paint* and the application of the parol evidence rule under Ohio law, as applied to the former. Although the primary issue

* The Honorable Karl S. Forester, Chief United States District Judge for the Eastern District of Kentucky, sitting by designation.

presented by the parties concerns the application of the parol evidence rule under Ohio law, the severability issue must first be addressed.

## JURISDICTION

We have jurisdiction over this interlocutory appeal pursuant to 28 U.S.C. §§ 1331, 1332 and 1367(a). Further, because the District Court denied the Appellants' motion to stay this action pending arbitration pursuant to section 3 of the Federal Arbitration Act ("FAA"), 9 U.S.C. § 3, we also have jurisdiction under 9 U.S.C. § 16(a)(1)(A).

While a "claim of fraud in the inducement of the entire contract" is a matter to be resolved by an arbitrator, "a claim of fraud in the inducement of the arbitration clause itself . . . the federal court" has jurisdiction to adjudicate it. *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. at 402-04 (emphasis added). *See C.B.S. Employees Fed. Credit Union v. Donaldson, Lufkin & Jenrette Sec. Corp.*, 912 F.2d 1563, 1567 (6th Cir. 1990) (stating that if a fraud claim relates to the making of the arbitration provision, the court must first adjudicate the fraud claim). Because the instant appeal involves allegations that the arbitration provisions at issue were fraudulently induced, the Court has jurisdiction over this appeal.

## BACKGROUND

The Appellee, Samuel Glazer ("Glazer" or "Appellee"), brought this action against Appellants Lehman Brothers, Inc. and affiliated investment companies (the "Lehman Brothers" companies) and Appellants SG Cowen Securities

Corp. and Societe Generale (the "SG Cowen" companies) (collectively, the "Appellants")[1] based on the alleged theft of Frank Gruttadauria ("Gruttadauria"), a former employee and broker with the Appellants. Glazer had several investment accounts with the Appellants through Gruttadauria.[2] Gruttadauria engaged in a complex system of fraud and theft as an investment broker during his approximately fifteen years working for the Appellants and has previously pled guilty to criminal charges relating to this wrongdoing.

In 1998, Glazer established investment accounts with the Appellants through Gruttadauria. In doing so, Glazer signed four contracts with SG Cowen: an account agreement, a margin agreement, an option contract, and an account agreement in connection with a prior, 1996 Option Agreement (collectively, the "Account Agreements"). Prior to the creation of those accounts with Gruttadauria, Glazer signed an Option Agreement with SG Cowen through broker David Tissue in 1996 (the "Tissue Account" or the "1996 Option Agreement"). Each of these five

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[1] Lehman Brothers purchased the assets and accounts of SG Cowen's Cleveland, Ohio office, including those owned by Glazer, in October 2000.

[2] Under Ohio law, "a fiduciary relationship is 'a relationship in which . . . [one reposes] special confidence and trust . . . in the integrity and fidelity of another,' thereby creating 'a position of superiority or influence, acquired by virtue of this special trust.'" *Andersons, Inc. v. Consol, Inc.*, 348 F.3d 496, 509 (6th Cir. 2003) (citing *Federated Management, Co. v. Coopers & Lybrand*, 137 Ohio App. 3d 366, 738 N.E.2d 842, 854 (Ohio 2000)). In their briefs before this Court, the parties have not disputed that the Defendants, through Gruttadauria, had a fiduciary duty of trust and confidence to the Plaintiff. Accordingly, the Court therefore assumes that the Appellants, through Gruttadauria, owed the Appellee Glazer a fiduciary duty.

agreements contain broad arbitration provisions[3] that are now at issue.

Glazer filed this action in 2002, seeking damages from the Appellants for Gruttadauria's misconduct and theft. Specifically, Glazer brings claims under the Securities and Exchange Act, 15 U.S.C. § 78j(b), other federal securities laws and Ohio state law. The Appellants claim that Glazer's claims should be submitted to arbitration pursuant to arbitration clauses contained in the five agreements.

This is the second time Glazer's claims have been presented to this Court. Previously, his claims were heard with six similar actions in a consolidated appeal, *Fazio v. Lehman Brothers, Inc.*, 340 F.3d 386 (6th Cir. 2003), after the District Court denied the appellants' motions to stay pending arbitration in those cases. The facts underlying this and other stockbroker fraud cases involving the Appellants and Gruttadauria were set forth in *Fazio*. *Id.* at 391-92.

In the prior appeal, a panel of this Court reversed the District Court's refusal to enforce the various arbitration agreements contained in the investment contracts with the Appellants. *Id.* at 395. The only question presented in that interlocutory appeal was whether similarly worded arbitration clauses in the various plaintiffs' brokerage account agreements mandated arbitration of their claims. *Id.* at 391. Because the panel could not reach the "fact-intensive

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[3] The broad arbitration clauses in the Account Agreements provide that "[a]ny controversy arising out of or relating to [Appellee Glazer's] accounts . . . shall be settled by arbitration." [J.A. at 811-18] The 1996 Option Agreement contains similar language. [J.A. at 809]

issues" regarding whether the arbitration clauses were enforceable, it remanded each action for a case-by-case "determination of whether the arbitration clauses, analyzed independently from the account agreements, are valid." *Id.* at 397-98. Thus, this Court specifically remanded with instructions to consider the particular claims of the plaintiffs regarding the validity of the arbitration clauses standing apart from the account agreements as a whole. *Id.* at 392.

Turning to the instant action, upon remand and following a period of discovery, the District Court held an evidentiary hearing on September 3, 2003, pursuant to 9 U.S.C. § 4. Subsequent to the hearing, on October 3, 2003, the District Court issued an Order and Memorandum Opinion that again denied the Appellants' motions to stay pending arbitration. Specifically, the District Court held that: (1) the parol evidence rule did not bar consideration of Gruttadauria's alleged oral promise to Glazer that SG Cowen would not enforce the arbitration provisions; (2) Glazer proved the elements of fraud in the inducement by clear and convincing evidence; and (3) the 1996 account agreement was superseded by Gruttaduaria's subsequent fraud and, therefore, the arbitration provision therein was not binding upon Glazer. [J.A. at 244-261]

In reaching its decision, the District Court held that "the arbitration provisions must be treated as contracts separate and distinct from the broader account agreements." [J.A. at 254] Yet, in reaching this conclusion, the District Court merely adopted Glazer's position without explaining how or why it reached this conclusion; nor did the District Court cite any authority for this legal proposition. Notably, the District Court framed the issue as:

> if an issue arises as to whether the parties intended to be bound by an alleged written contract, parol evidence is admissible to show that despite the writing, the parties did not enter any agreement. . . . However, if the parties generally intended to be bound by a written agreement, parol evidence is inadmissible to directly contradict one of its terms. The parties essentially dispute which situation is present in the current case.

[J.A. at 254] We find that the District Court properly identified the main issue, but, as discussed infra, engaged in an improper application of the appropriate rules.

Relying on *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 18 L. Ed. 2d 1270, 87 S. Ct. 1801, the District Court held that the "severability doctrine" dictates that the "arbitration provisions must be treated as contracts separate and distinct from the broader account agreements." [J.A. at 254] Thus, the District Court held that parol evidence was admissible to prove that the parties lacked intent to be bound by the "separate" arbitration clause notwithstanding the signed Account Agreements. [J.A. at 254] Based on these legal conclusions, the District Court then found that Glazer proved each element of fraudulent inducement by clear and convincing evidence. [J.A. at 256-260] In addition, the District Court also held that the 1996 Option Agreement did not require arbitration because it was superseded by Gruttadauria's conduct and by the closing of the Tissue account. [J.A. at 260]

Appellants SG Cowen filed a timely Notice of Appeal on October 6, 2003, and Appellants Lehman Brothers timely filed their Notice of Appeal on October 21, 2003.

LEGAL STANDARD

We review de novo the district court's conclusions of law and determination on whether to compel arbitration pursuant to the FAA. *Burden v. Check into Cash of Kentucky, LLC*, 267 F.3d 483, 487 (6th Cir. 2001). A district court's findings of fact are reviewed for clear error. *Great Earth v. Simons*, 288 F.3d 878, 888 (6th Cir. 2002). However, it is well-established that any doubts regarding arbitrability must be resolved in favor of arbitration, *Fazio v. Lehman Bros., Inc.*, 340 F.3d at 392, because there is a strong presumption in favor of arbitration under the FAA. *O.J. Distrib., Inc. v. Hornell Brewing Co.*, 340 F.3d 345, 355 (6th Cir. 2003). Additionally, because of the strong presumption in favor of arbitration, waiver of the right to arbitration is not to be lightly inferred. *Id.*

Before this Court can send a case to arbitration, we must first determine whether a valid agreement to arbitrate exists. 9 U.S.C. § 2; *Fazio v. Lehman Bros., Inc.* 340 F.3d at 393. An arbitration agreement may be voided for the same reasons for which any contract may be invalidated, including forgery, unconscionability, and lack of consideration. *Id.* In making this determination, "ordinary state-law principles that govern the formation of contracts" will apply to this analysis. *Id.* at 394 (citing *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 944, 131 L. Ed. 2d 985, 115 S. Ct. 1920 (1995)). Accordingly, the substantive law of Ohio regarding contract formation, interpretation and defenses thereto will be examined.

In this appeal, the Court is called upon, yet again, to examine *Prima Paint* and its application to the validity of arbitration clauses when claims of fraudulent inducement are raised concerning the making of those clauses, as

opposed to the entire agreement. "There is a general presumption of arbitrability, and any doubts are to be resolved in favor of arbitration 'unless it may be said with positive assurance that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute.'" *Highlands Wellmont Health Network, Inc. v. John Deere Health Plan, Inc.*, 350 F.3d 568, 576-77 (6th Cir. 2003) (quoting *AT & T Techs., Inc. v. Communications Workers of Am.*, 475 U.S. 643, 650, 89 L. Ed. 2d 648, 106 S. Ct. 1415 (1986)). Further, where, as in the instant action, the arbitration clause is broad, "only an express provision excluding a specific dispute, or 'the most forceful evidence of a purpose to exclude the claim from arbitration,' will remove the dispute from consideration by the arbitrators." *Highlands Wellmont*, 350 F.3d at 577 (quoting *AT & T Techs.*, 475 U.S. at 650). Of course, "while ambiguities in the language of the agreement should be resolved in favor of arbitration, we do not override the clear intent of the parties, or reach a result inconsistent with the plain text of the contract, simply because the policy favoring arbitration is implicated." *EEOC v. Waffle House, Inc.*, 534 U.S. 279, 294,, 151 L. Ed. 2d 755 122 S. Ct. 754 (2002) (internal citations omitted). *See Masco Corp. v. Zurich American Ins. Co.*, 382 F.3d 624, 627 (6th Cir. 2004).

ANALYSIS

A. Overview Of The Federal Arbitration Act.

The Federal Arbitration Act ("FAA") provides that arbitration clauses in commercial contracts "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. If a plaintiff's cause of action is covered by an arbitration clause, the court must stay the proceedings

until the arbitration process is complete. 9 U.S.C. § 3. In order to compel arbitration, a court must conduct a hearing, and:

> upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement. . . . If the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to the trial thereof.

9 U.S.C. § 4. Under this statutory scheme, the district court must make a number of threshold determinations before compelling arbitration:

> when considering a motion to stay proceedings and compel arbitration under the Act, a court has four tasks: first, it must determine whether the parties agreed to arbitrate; second, it must determine the scope of that agreement; third, if federal statutory claims are asserted, it must consider whether Congress intended those claims to be nonarbitrable; and fourth, if the court concludes that some, but not all, of the claims in the action are subject to arbitration, it must determine whether to stay the remainder of the proceedings pending arbitration.

*Stout v. J.D. Byrider*, 228 F.3d 709, 714 (6th Cir. 2000). *See also Fazio v. Lehman Brothers*, 340 F.3d at 392-94.

It is well-established that any doubts regarding arbitrability should be resolved in favor of arbitration. *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25, 74 L. Ed. 2d 765, 103 S. Ct. 927 (1983). In

addition, the Supreme Court has held that the FAA preempts state law regarding arbitration. *Southland Corp. v. Keating*, 465 U.S. 1, 10-11, 79 L. Ed. 2d 1, 104 S. Ct. 852 (1984). State contract law, however, governs in determining whether the arbitration clause itself was validly obtained, provided the contract law applied is general and not specific to arbitration clauses. *Doctor's Assoc., Inc. v. Casarotto*, 517 U.S. 681, 686-87, 134 L. Ed. 2d 902, 116 S.Ct. 1652 (1996); *Great Earth Cos. v. Simons*, 288 F.3d at 889.

In this case, the crux of the District Court's decision was its legal conclusion that the arbitration provisions of the Account Agreements "must be viewed as distinct contracts subject to invalidity independent of the broader account agreements." [J.A. at 254] Based on that finding, the District Court then decided that parol evidence, therefore, was admissible to show fraudulent inducement to be bound by the arbitration provisions. [J.A. at 254-55] Then, relying on Glazer's oral testimony, the court found, by clear and convincing evidence, that Glazer proved his fraudulent inducement claim and the arbitration provisions could not be enforced. This appeal followed.[4]

Accordingly, the first issue presented is whether an arbitration clause itself constitutes an independent contract isolated from the agreement in which it is contained

[4] Unfortunately, this case is indicative of the exact problem that Congress intended to eliminate by passing the FAA. Specifically, Congress intended that arbitration "be speedy and not subject to delay and obstruction in the courts." *Prima Paint*, 388 U.S. at 404. The instant action has been in litigation for over two and a half years and the parties are still disputing whether to submit this matter to arbitration rather than resolving the merits of Glazer's claims.

or whether such clause should be considered a "separate" contract. No panel of this Court has yet addressed this narrow question directly and, thus, the issue is one of first impression.

B. The District Court Erred By Concluding That The Arbitration Clauses Contained In The Account Agreements Are "Separate And Independent Contracts."

Section 2 of the FAA, 9 U.S.C. § 2, provides that an arbitration clause "shall be valid, irrevocable, and enforceable save upon such grounds as exist at law or in equity for the revocation of any contract." *Id.* (emphasis added). The question presented in this appeal is whether this mandate, that an arbitration provision can be invalidated on the same grounds as the revocation of a contract, means that the arbitration provision is actually a "separate contract" or is merely to be examined "separate" from the overall contract at issue for the limited purpose of determining arbitrability.

The leading Supreme Court decision on this issue is *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 18 L. Ed. 2d 1270, 87 S. Ct. 1801. Therein, the Supreme Court held that a "claim of fraud in the inducement of the entire contract" is a matter to be resolved by the arbitrators, not the federal courts. *Id.* at 402-04. However, if there is an alleged fraud that "goes to the 'making' of the agreement to arbitrate," as in the instant case, a federal court may adjudicate that issue. *Id.* at 403-04. In reaching that decision, the Supreme Court relied on the explicit statutory language of Section 4 of the Federal Arbitration Act:

> Under [section] 4, with respect to a matter within the jurisdiction of the federal courts save for the existence of an arbitration clause, the federal court is instructed to order arbitration to proceed once it is satisfied that "the making of the agreement for arbitration or the failure to comply (with the arbitration agreement) is not in issue." Accordingly, if the claim is fraud in the inducement of the arbitration clause itself – an issue which goes to the "making" of the agreement to arbitrate – the federal court may proceed to adjudicate it. . . . We hold, therefore, that in passing upon a [section] 3 application for a stay while the parties arbitrate, a federal court may consider only issues relating to the making and performance of the agreement to arbitrate.

*Id.* (footnotes omitted) (emphasis added).

In other words, a district court is instructed to order arbitration to proceed once it is satisfied that "the making of the agreement for arbitration or the failure to comply (with the arbitration agreement) is not in issue." *Id.* at 403. Thus, even if there was fraudulent inducement to sign the contract as a whole, by the terms of Sections 3 and 4 of the FAA, the arbitration clause is severable and will only be voided for some error in its making. *Fazio v. Lehman Bros., Inc.*, 340 F.3d at 393. *See also Ferro Corp. v. Garrison Indus.*, 142 F.3d 926, 933 (6th Cir. 1998).

This Circuit has interpreted *Prima Paint* to mean that arbitration clauses are "separable" from the contracts in which they are included when examining whether those provisions were fraudulently induced. *See, e.g., Burden v. Check into Cash*, 267 F.3d at 488. Yet, contrary to the District court's conclusion and Glazer's arguments, the Supreme Court in *Prima Paint* did not hold that arbitration

provisions in contracts are "severable" to such an extent that they should be considered separate and distinct contracts. Rather, the Supreme Court held merely that arbitration clauses should be reviewed to determine whether the dispute should be referred to arbitration (primarily because Section 4 of the FAA explicitly directs the courts to order arbitration once the arbitration clause is no longer at issue). *Id.* at 403. In other words, arbitration provisions are "severable" because the FAA does not permit the courts to examine the enforceability of contracts containing arbitration provisions. *Id.* at 404. Thus, nothing in *Prima Paint* actually states or provides that arbitration provisions are to be considered separate, distinct and independent contracts, as the District Court concluded.

For the reasons discussed herein, arbitration provisions, although severable insofar as they are considered in determining whether a contractual dispute should be submitted to arbitration, are not "separate, independent and distinct contracts." Although *Prima Paint* clearly requires courts to separately examine arbitration clauses, those clauses should not be considered as "separate contracts" outside of the underlying agreement.

To begin, various courts have routinely discussed why arbitration provisions are not subject to scrutiny as independent contracts in other contexts. For example, in *Wilson Electrical Contractors, Inc. v. Minnotte Contracting Corp.*, 878 F.2d 167 (6th Cir. 1989), the only decision from this Circuit touching on the issue, the plaintiff argued that *Prima Paint* should "be interpreted as implying that an arbitration clause is an independent contract that is separable from the main contract in which it is found and therefore must have all essential elements of a contract,

including consideration." *Id.* at 169. Yet, the panel rejected this position and stated that "[s]uch an interpretation of *Prima Paint* would, however, clearly be inappropriate given the Supreme Court's recent decision in several arbitration cases." *Id.* In fact, the Court noted in footnote 2 of its decision that "the Supreme Court's characterization of arbitration clauses as independent, separable contracts in *Prima Paint*, which was decided in 1967, may be regarded less than persuasive in light of the holdings of the Court in its more recent [FAA] cases." *Id.* at 169, n. 2. The *Wilson Electrical* Court then pointed out that recent decisions of the Supreme Court following *Prima Paint* have consistently emphasized that the FAA is grounded on a strong federal policy favoring arbitration. *Id.* at 169. Based on this analysis, the Court then rejected the claim that an arbitration clause requires separate "consideration" to be enforceable, thereby implying that such provisions are not independent contracts either. *Id.*

Similarly, other circuits have held that "mutuality" is not a requirement of a valid arbitration clause. *See, e.g., Harris v. Green Tree Financial Corp.*, 183 F.3d 173, 180 (3rd Cir. 1999). In *Doctor's Associates, Inc. v. Distajo*, 66 F.3d 438 (2nd Cir. 1995), the Court examined *Prima Paint* and its reliance on a prior Second Circuit case and held that "one might argue, [*Prima Paint*] indicates that an arbitration clause must be treated as a contract supported by independent consideration. For the following reasons, however, we reject this characterization." *Id.* at 452. In reaching its decision in *Distajo*, the Court clarified that *Prima Paint* merely

> indicated only that arbitration clauses are 'separable' from void or voidable provisions of a contract – not that they are independent contracts.

> Although we consider an arbitration clause separately for the limited purpose of evaluating a claim of fraudulent inducement, we do not do so for all purposes.

*Id.* (emphasis added). Thus, the Court ultimately decided that mutuality of obligation was not required to enforce an arbitration agreement if the underlying contract is supported by consideration. *Id.* at 451-53.

Similar decisions implying that arbitration provisions are not separate, independent contracts were reached in *Barker v. Golf U.S.A., Inc.*, 154 F.3d 788, 792 (8th Cir. 1998) (concluding "that, under Oklahoma law, mutuality of obligation is not required for arbitration clauses so long as the contract as a whole is supported by consideration"); *Dorsey v. H.C.P. Sales, Inc.*, 46 F. Supp. 2d 804, 806-07 (N.D.Ill. 1999) (holding that an arbitration clause is not unenforceable for lack of identical obligations); *Randolph v. Green Tree Fin. Corp.*, 991 F. Supp. 1410, 1421-22 (M.D.Ala. 1997) (rejecting claim that arbitration clause that required one party to arbitrate all claims, while giving the second party the option not to arbitrate anything, was invalid); *Pate v. Melvin Williams Manufactured Homes, Inc.*, 198 B.R. 841, 844 (Bankr.S.D.Ga. 1996) (rejecting argument that arbitration agreement lacked mutuality because defendant company could sue over certain issues, while consumer had to arbitrate all claims). *Cf., Great Earth Co., Inc. v. Simons*, 2000 U.S. Dist. LEXIS 3772, 2000 WL 310354 (S.D.N.Y. March 24, 2000), opinion withdrawn in part on reconsideration, 2000 U.S. Dist. LEXIS 6889, 2000 WL 640829 (S.D.N.Y. May 18, 2000) (withdrawing part of opinion wherein the district court initially found that it would have found no "meeting of the minds" existed as to the arbitration clause or arbitration

forum clause). Accordingly, other courts addressing related issues have rejected similar legal arguments made by Glazer and adopted by the District court in this case, and these decisions thus give additional persuasive authority against the position that arbitration clauses should be construed as separate, independent contracts.

If arbitration clauses cannot be considered "independent contracts" when examining contractual formation issues, like mutuality or consideration, how much more so should such provisions not be considered "separate contracts" when examining other enforceability issues, such as when examining whether an arbitration clause was fraudulently induced. In other words, based on the foregoing, it is clear to us that arbitration clauses should not be considered "separate contracts" at all. Rather, in accordance with *Prima Paint*, arbitration agreements contained in larger contracts should be considered "separate" from the contract only insofar as a federal court (as opposed to the arbitrator) can examine whether the arbitration clause was fraudulently induced or is otherwise unenforceable.

C. The District Court Erred In Deciding That The Parol Evidence Rule Did Not Bar Glazer's Testimony.

During the evidentiary hearing before the District Court, Glazer testified that Gruttadauria promised or represented to him that the arbitration provisions contained in the Account Agreements would not be enforced against him, as the Account Agreements were mere formalities to the creation of the accounts with the Appellants. Based on this extrinsic evidence, Glazer now asserts that the arbitration provisions in the Account Agreements are not enforceable because they were fraudulently induced.

Conversely, the Appellants argue that allegations of fraudulent inducement of a specific provision in an agreement, such as those made by Glazer herein, cannot be used to contradict the terms and provisions of a signed, written contract. They further argue that the parol evidence rule bars Glazer's evidence of fraudulent inducement as a matter of law. Specifically, they contend that testimony and extrinsic evidence regarding Gruttadauria's alleged oral assurances that SG Cowen would not enforce the arbitration clauses, which directly contradicts the written terms of the executed account agreements, are not admissible to prove any agreement that contradicts the written terms of the Account Agreements.

Generally,

> when two parties have made a contract and have expressed it in a writing to which they have both assented as the complete and accurate integration of that contract, evidence, whether parol or otherwise, of antecedent understandings and negotiations will not be admitted for the purpose of varying or contradicting the writing.

3A Corbin, Contracts § 573 at 357 (1960). The parol evidence rule, as construed by Ohio courts, states "absent fraud, mistake or other invalidating cause, the parties' final written integration of their agreement may not be varied, contradicted or supplemented by evidence of prior or contemporaneous oral agreements, or prior written agreements." *Galmish v. Cicchini*, 90 Ohio St.3d 22, 2000 Ohio 7, 734 N.E.2d 782, 788 (Ohio 2000) (citing 11 Williston on Contracts 569-70, § 33.4 (4 Ed. 1999)). Thus, absent fraud, mistake or some other invalidating cause, prior or contemporaneous oral agreements may not be used to alter, contradict, contest, or vary an integrated written agreement.

*Galmish*, at 788. Contrary to its name, this rule is one of substantive contractual, not evidentiary, law. *Id.*

In *Galmish*, the most recent Ohio opinion discussing the parol evidence rule at length, the Ohio Supreme Court considered whether the plaintiff's claims were barred by that rule. Specifically, the issue in *Galmish* was whether parol evidence was admissible to prove a breach of contract claim when the written contract at issue imposed no affirmative duties to engage in certain performance. The court ultimately found that the parol evidence rule did not bar evidence of the breach of contract claim because the extrinsic evidence went to the making of the contract, not to a provision of that contract. Explaining the nature, history and application of this rule, the court stated:

> The parol evidence rule, as is now universally recognized, is not a rule of evidence but is one of substantive law. It does not exclude evidence for any of the reasons ordinarily requiring exclusion, based on the probative value of such evidence or the policy of its admission. The rule as applied to contracts is simply that as a matter of substantive law, a certain act, the act of embodying the complete terms of an agreement in a writing (the 'integration'), becomes the contract of the parties. The point then is, not how the agreement is to be proved, because as a matter of law the writing is the agreement. Extrinsic evidence is excluded because it cannot serve to prove what the agreement was, this being determined as a matter of law to be the writing itself. The rule comes into operation when there is a single and final memorial of the understanding of the parties. When that takes place, prior and contemporaneous negotiations, oral or written, are excluded; or, as it is

> sometimes said, the written memorial supersedes these prior or contemporaneous negotiations.

*Id.* at 788-89 (citation omitted); accord *Watkins & Son Pet Supplies v. Iams Co.*, 254 F.3d 607, 612 (6th Cir. 2001) (citing *Galmish* and stating "the parol evidence rule does not operate to prohibit proof of terms of the agreement; instead, it provides that parol terms are not terms of the agreement at all"). The principle policy behind the rule is to protect the integrity and purpose of written agreements. *Galmish*, at 789 (citation omitted).

However, under Ohio law, "the parol evidence rule does not prohibit a party from introducing parol or extrinsic evidence for the purpose of proving fraudulent inducement." *Id.* But *cf. Coal Resources, Inc. v. Gulf & Western Indus., Inc.*, 756 F.2d 443, 447 n. 2 (6th Cir. 1985) (indicating that defendant's alleged promise was one of future performance rather than a representation of past or present material fact, and because "the purpose of an integration clause is to preclude reliance upon promises of future performance that have not been included in the contract," that case did not involve a claim of fraud in the inducement). Yet,

> the principle which prohibits the application of the parol-evidence rule in cases of fraud inducing the execution of a written contract * * * has been regarded as being as important and as resting on as sound a policy as the parol-evidence rule itself. It has been said that if the courts were to hold, in an action on a written contract, that parol evidence should not be received as to false representations of fact made by the plaintiff, which induced the defendant to execute the contract, they would in effect hold that the maxim that fraud vitiates every transaction is no longer

> the rule; and such a principle would in a short time break down every barrier which the law has erected against fraudulent dealing.
>
> Fraud cannot be merged; hence the doctrine, which is merely only another form of expression of the parol-evidence rule, that prior negotiations and conversations leading up to the formation of a written contract are merged therein, is not applicable to preclude the admission of parol or extrinsic evidence to prove that a written contract was induced by fraud.

*Id.* at 789 (citation omitted) (emphasis added). In other words:

> It was never intended that the parol evidence rule could be used as a shield to prevent the proof of fraud, or that a person could arrange to have an agreement which was obtained by him through fraud exercised upon the other contracting party reduced to writing and formally executed, and thereby deprive the courts of the power to prevent him from reaping the benefits of his deception or chicanery.

*Id.* (citation omitted). *See also F.W. Dodge Corp. v. Fultz*, 85 Ohio L. Abs. 472, 175 N.E.2d 543, 546 (Ohio App. 1961) ("it is nevertheless clear that the parol evidence rule does not preclude a party from showing that a writing which apparently constitutes a contract, was not intended or understood by either party to be binding upon them").

Yet, notwithstanding the foregoing principles, this rule may not be side-stepped by

> a fraudulent inducement claim which alleges that the inducement to sign the writing was a promise, the terms of which are directly contradicted by

> the signed writing. Accordingly, an oral agreement cannot be enforced in preference to a signed writing which pertains to exactly the same subject matter, yet has different terms.

*Galmish*, at 790 (citation omitted) (emphasis added). Stated differently, under Ohio law,

> the Parol Evidence Rule will not exclude evidence of fraud which induced the written contract. But, a fraudulent inducement case is not made out simply by alleging that a statement or agreement made prior to the contract is different from that which now appears in the written contract. Quite to the contrary, attempts to prove such contradictory assertions is exactly what the Parol Evidence Rule was designed to prohibit.

*Id.* (citation omitted). Accordingly, "the parol evidence rule does apply 'to such promissory fraud if the evidence in question is offered to show a promise which contradicts an integrated written agreement. Unless the false promise is either independent of or consistent with the written instrument, evidence thereof is inadmissible.'" *Id.* at 790-91 (citation omitted) (emphasis added). *See Watkins & Son Pet Supplies v. Iams Co.*, 254 F.3d 607, 613 (6th Cir. 2001) (citing *Galmish*, 734 N.E.2d at 791) (stating "'fraud in the inducement,' in the sense intended in *Coal Resources* and *Galmish*, is a fraudulent misstatement of fact [as opposed to promissory fraud] that induces a party to enter a contract, not a fraudulent promise of future performance that is within the scope of the subject matter of the written contract but that was not included in it.")

As in *Watkins*, Glazer's claim is not one alleging a fraudulent misstatement of fact, but one alleging "a fraudulent promise of future performance that is within

the scope of the subject matter of the written contract but that was not included in it." *Watkins*, 254 F.3d at 613. The fraudulent promise that Glazer is alleging is not only within the scope of the subject matter of the written contract and not included therein, but directly contradictory to the terms of the signed written agreements.[5]

In *Watkins*, this Court examined a promissory fraud claim in which the plaintiff alleged that it was fraudulently induced into signing an agreement based on a promise of future performance by the defendant which was not included in the contract and which the defendant failed to fulfill. *Id.* Relying on *Galmish*, the Court held that parol evidence was not admissible to show "a promise which contradicts an integrated written agreement." *Id.* (quoting *Galmish*, 734 N.E.2d at 791). The court held that the promise was neither "independent of nor consistent with the written instrument," and as such parol evidence was inadmissible. *Id.* (quoting *Galmish*, 734 N.E.2d at 791). *See also National City Bank, Akron v. Donaldson*, 95 Ohio App. 3d 241, 642 N.E.2d 58, 60 (Ohio App. 1994).

Similarly, in *Coal Resources*, 756 F.2d 443, this Court held that parol evidence was admissible to show that the

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[5] For a discussion of the distinction between fraud in the factum and promissory fraud in the inducement under Ohio law *see Williams v. Edwards*, 129 Ohio App. 3d 116, 717 N.E.2d 368, 374 (Ohio App. 1 Dist. 1998) ("Furthermore, fraud is generally predicated on a misrepresentation relating to a past or existing fact, and not on promises or representations relating to future actions or conduct. An exception to this rule exists, however, where an individual makes a promise concerning a future action, occurrence, or conduct and, at the time he makes it, has no intention of keeping the promise. In such a case, the individual possesses actual fraudulent intent and a claim for fraud may be asserted against him.") (emphasis added). *See also Burden v. Check Into Cash of Kentucky, LLC*, 267 F.3d 483, 488-89.

promisor had no intention of performing the promises that were included in the agreement, but was not admissible to show that the promisor had no intention of performing the promise that was not included in the agreement. *Id.* at 446-47. Finally, the parol evidence admitted in *Galmish*, 734 N.E.2d at 791, itself did not "seek to contradict or vary the terms of the written agreement." *Id.* Instead, the fraud alleged was that the promisor, at the time of entering into the agreement, had no intention of performing a condition precedent to the promisee's ability to benefit from the contract as written. *Id.*

In reaching its decision in this case, the District Court relied on *F.W. Dodge Corp. v. Fultz*, 85 Ohio L. Abs. 472, 175 N.E.2d 543, and *National City Bank, Akron v. Donaldson*, 95 Ohio App. 3d 241, 642 N.E.2d 58. However, these cases are distinguishable and were erroneously relied upon. In *Fultz*, the court held that the parol evidence rule did not prohibit a party from proving that a written agreement (as opposed to a provision in that agreement) was not intended or understood by either party to be binding upon them. *Fultz*, at 546. In fact, the court permitted the defendant Fultz to introduce testimony as to certain oral conversations and oral promises that the plaintiff's corporate representative and sales person had made that the company would not enforce the one-year subscription agreement at issue. Thus, unlike the instant action, which involves the enforceability of a provision in the account agreements, the issue in *Fultz* was whether the parties intended the contract as a whole to be binding upon them. *Id.* at 546. Accordingly, the application of the parol evidence rule in *Fultz* is inapplicable in this case because the arbitration provisions at issue in the Account Agreements are not independent contracts.

Similarly, in *Donaldson*, 95 Ohio App. 3d 241, 642 N.E.2d 58, in deciding whether the parol evidence rule was applicable, the court asked whether the parties intended the signed document, the alleged contract, to be a complete and accurate integration of the agreement between the parties. The appellate court permitted evidence that Donaldson and the bank, through a sales person, did not intend the written and signed document (again, as opposed to a provision or term of that agreement) to be an enforceable contract. Thus, *Donaldson* is also inapposite and distinguishable from the instant action.

In this case, Glazer seeks to introduce evidence of a promise that directly contradicts a term of the integrated written agreement. Here, the parties have not disputed, and we therefore assume, that the Account Agreements at issue are integrated contracts.[6] Further, Glazer is not asking us to invalidate the contract on the ground that SG Cowen had no intention of performing it. Instead, he is asking us to admit evidence to show that Gruttaduaria made an oral promise not to enforce the arbitration clause – a promise directly contradicted by the language of the agreement. *See Galmish*, 734 N.E.2d at 790 (assertion that there was "a statement or agreement made prior to the contract [that] is different from that which now appears in the written contract" are exactly the type which the "Parol

[6] The parties have not raised any issue regarding whether the agreements are integrated, written contracts. While a prerequisite to the parol evidence rule is that the contract must be a complete and accurate integration of the parties' agreement, a document that appears, on its face, to be a complete and accurate integration will sufficiently meet this requirement. *See, e.g., National City Bank, Akron, v. Donaldson*, 642 N.E.2d at 60.

Evidence Rule was designed to prohibit"). Glazer does not claim that the parties never intended for the Account Agreements signed and executed by him to be unenforceable or not binding upon them; in fact, he relies upon those account agreements as the basis for his claims against the Appellants. Rather, he argues that the parties never intended for the arbitration provisions at issue, as opposed to the Account Agreements, to be binding.

Thus, the distinction regarding whether an arbitration provision is a separate, distinct contract or whether it is merely "severable" in determining whether to send a dispute to arbitration, as discussed *supra*, becomes critical. In this case, it is undisputed that Glazer freely signed the Account Agreements that contained arbitration clauses allowing the Appellants to elect to arbitrate any controversy or claim arising out of or relating to the contracts or the breaches thereof. [J.A. at 811-18] Further, the Account Agreements also each contain a clause providing that these "Agreements [are] not subject to any oral modification and it may only be amended or modified in a writing signed by [SG Cowen]." [J.A. at 811-18]

It is clear that, under Ohio law, the parol evidence rule prohibits a party from challenging the terms of a written contract through the use of extrinsic evidence, such as that proffered by Glazer in this case. Accordingly, based upon Ohio law and the facts of this case, Glazer cannot challenge the enforceability of the arbitration provisions within the Account Agreements through the use of parol evidence. *See Galmish*, at 791. As a result, the District Court erred as a matter of law when it held that parol evidence was admissible to prove that Glazer was fraudulently induced to agree to the Account Agreements containing the arbitration clauses at issue. Thus, it was

also error when it considered Glazer's testimony regarding Gruttadauria's oral promises that the arbitration provisions would not be enforced.

D. The District Court Erred In Finding That Glazer Was Fraudulently Induced To Sign The Account Agreements Containing Arbitration Clauses.

As a result of the District Court's reliance upon Glazer's oral testimony, it concluded that Glazer had sufficiently proven that he was fraudulently induced to sign the arbitration provisions at issue. [J.A. at 250-61] In reaching its decision, the District Court relied wholly upon that oral testimony. [J.A. at 246, 248-49, 250-51, 255, 256-61] As stated above, Glazer's oral testimony, being parol evidence, was inadmissible and should not have been relied upon in examining the Appellants' motion to stay pending arbitration. Absent this inadmissible parol evidence, there is insufficient evidence in the record for any factual finding of fraudulent inducement[7] in the making of the arbitration provision. In fact, this parol evidence appears to be the only evidence relied upon by the District Court in reaching its decision. As a result, the elements of fraudulent inducement cannot be satisfied. The Court thus

[7] Under Ohio law, a Plaintiff must prove six elements in order to prove fraudulent inducement. He must prove by clear and convincing evidence that: (1) a representation, or where there is a duty to disclose, a concealment of fact; (2) which is material in nature; (3) was made falsely with knowledge of its falsity or with utter disregard or recklessness as to whether it is true or false that knowledge may be inferred; (4) with the intent of misleading another to rely upon said misrepresentation or concealment; (5) which results in justifiable reliance upon that representation or concealment; and (6) proximately causing some injury. *Davis v. Sun Refining and Marketing Co.*, 109 Ohio App. 3d 42, 671 N.E.2d 1049, 1058 (Ohio App. 1996).

finds that the District Court's factual findings as to the fraudulent inducement claim were clearly erroneous. *See, e.g., Great Earth v. Simons*, 288 F.3d at 888.

Accordingly, there being no admissible evidence to support the fraudulent inducement claim, a valid agreement to arbitrate exists pursuant to the arbitration clauses contained in the four Account Agreements. As a result, Glazer's claims against the Defendants-Appellants are covered by enforceable arbitration clauses, and the District Court should have stayed this matter until the arbitration process was complete. *See* 9 U.S.C. § 3. Its decision was not in accord with the FAA's mandate and innumerable decisions from this Circuit favoring arbitration agreements and resolving doubts about arbitrable issues in favor of arbitration and, therefore, cannot be sustained. *See, e.g., Masco Corp. v. Zurich North American Ins. Co.*, 382 F.3d 624 (6th Cir. 2004).

E. The District Court Did Not Err In Holding That The Arbitration Clause Contained In The 1996 Option Agreement Was Rendered Unenforceable Because It Was Modified And/Or Superceded By Subsequent Events And/Or Conduct.

The Appellants also contend that the District Court erred in holding that the 1996 Option Agreement and the arbitration provision contained therein was not applicable to this case. [J.A. at 260] The District Court found that "whatever obligations [the 1996 Options Agreement] may have imposed initially, this agreement was superseded by Gruttadauria's conduct in 1998. In 1998, the Tissue account was effectively closed and all the assets were transferred to the new Gruttadauria account." As a result, the court held that the Options Agreement for the defunct

Tissue Account cannot be used to side step Gruttadauria's later representations. [J.A. at 260.]

It is undisputed that the 1998 Account Agreements effectively closed the Tissue Account and transferred the Tissue Account assets into new accounts with the Appellants under Gruttadauria's management. It is a fundamental precept of contract law that parties may agree to discharge or terminate a contract in favor of creating a second agreement to replace the former, and, when that occurs, the initial agreement is superceded and is no longer enforceable as to any party thereto. *See* 3A Corbin on Contracts § 574 (1960); Restatement (Second) of Contracts § 279 (1979); 17A Am.Jur.2d Contracts § 539 (2004). Thus, as noted in the Restatement, parties may substitute one contract for another, thereby discharging the pre-existing duty of the one party and extinguishing the other's right to enforce the original duty. Restatement (Second) of Contracts § 279.

In the case sub judice, when the parties agreed to close the Tissue Account and terminate the 1996 Option Agreement, the parties substituted one of the 1998 Account Agreements for the 1996 Option Agreement. The arbitration clause contained in the 1996 Option Agreement was legally substituted, and therefore superseded, by the subsequent Account Agreements. Thus, any arbitration provision in the 1996 Option Agreement is no longer enforceable and is inapplicable to this action. As a result, the Court need not address whether Gruttadauria's subsequent criminal conduct superceded the 1996 Option Agreement because the substitution of the four Account Agreements supercedes the 1996 arbitration provision.

Therefore, the District Court's decision on this issue must be sustained.

## CONCLUSION

Accordingly, for the reasons discussed *supra*, we will AFFIRM, in part, REVERSE, in part, and REMAND this case for proceedings not inconsistent with this opinion.

No. 02-3820 Robert Fazio, et al., Plaintiffs-Appellees, v. Lehman Brothers, Inc.; Lehman Brothers Holdings, Inc., Defendants, S.G. Cowen Securities Corporation; Societe Generale, Defendants-Appellants, Hambrecht & Quist, Inc.; J.P. Morgan Chase & Company, Defendants. No. 02-3821 Robert Fazio, et al., Plaintiffs-Appellees, v. Lehman Brothers, Inc.; Lehman Brothers Holdings, Inc., Defendants-Appellants, S.G. Cowen Securities Corporation; Societe Generale; Hambrecht & Quist, Inc.; J.P. Morgan Chase & Company, Defendants. No. 02-3822 Robert Fazio, et al., Plaintiffs-Appellees, v. Lehman Brothers, Inc.; Lehman Brothers Holdings, Inc.; S.G. Cowen Securities Corporation; Societe Generale, Defendants, Hambrecht & Quist, Inc.; J.P. Morgan Chase & Company, Defendants-Appellants. No. 02-3823 Robert Fazio, et al., Plaintiffs, Samuel Glazer, Plaintiff-Appellee, v. Lehman Brothers, Inc.; Lehman Brothers Holdings, Inc., Defendants, S.G. Cowen Securities Corporation; Societe Generale, Defendants-Appellants. No. 02-3824 Robert Fazio, et al., Plaintiffs, Samuel Glazer, Plaintiff-Appellee, v. Lehman Brothers, Inc.; Lehman Brothers Holdings, Inc., Defendants-Appellants, S.G. Cowen Securities Corporation; Societe Generale; Hambrecht & Quist, Inc.; J.P. Morgan Chase & Company, Defendants. No. 02-3825 Robert Fazio, et al., Plaintiffs, Dominic A. Visconsi, Sr., et al., Plaintiffs-Appellees, v. Lehman Brothers, Inc.; Lehman Brothers Holdings, Inc., Defendants, S.G. Cowen Securities Corporation; Societe Generale, Defendants-Appellants. No. 02-3826 Robert Fazio, et al., Plaintiffs, Dominic A. Visconsi, Sr., et al., Plaintiffs-Appellees, v. Lehman Brothers, Inc.; Lehman Brothers Holdings, Inc., Defendants-Appellants, S.G. Cowen Securities Corporation; Societe Generale, Defendants. No. 02-3867 Peter A. Spitalieri, Plaintiff-Appellee, v. Lehman Brothers, Inc.; Lehman Brothers Holdings, Inc., Defendants, S.G. Cowen Securities Corporation; Societe Generale, Defendants-Appellants. No. 02-3868 Peter A. Spitalieri, Plaintiff-Appellee, v. Lehman Brothers, Inc.; Lehman

Brothers Holdings, Inc., Defendants-Appellants, S.G. Cowen Securities Corporation; Societe Generale, Defendants. No. 02-3869 Richard Lopardo, et al., Plaintiffs-Appellees, v. Lehman Brothers, Inc.; Lehman Brothers Holdings, Inc., Defendants, S.G. Cowen Securities Corporation, Defendant-Appellant. No. 02-3870 Richard Lopardo, et al., Plaintiffs-Appellees, v. Lehman Brothers, Inc., Defendant-Appellant, S.G. Cowen Securities Corporation, Defendant. No. 02-3873 Peter M. Bonutti, M.D., Plaintiff-Appellee, v. Lehman Brothers, Inc., Defendant, S.G. Cowen Securities Corporation, Defendant-Appellant. No. 02-3874 Peter M. Bonutti, M.D., Plaintiff-Appellee, v. Lehman Brothers, Inc., Defendant-Appellant, S.G. Cowen Securities Corporation, Defendant. No. 03-3041 Robert Fazio, et al., Plaintiffs-Appellees, v. Cowen & Company, Defendant-Appellant. Nos. 03-3042/03-3258 Dominic A. Visconsi, Sr., et al., Plaintiffs-Appellees, v. Cowen & Company, Defendant-Appellant. No. 03-3043 Richard Lopardo, et al., Plaintiffs-Appellees, v. Cowen & Company, Defendant-Appellant. No. 03-3045 Peter M. Bonutti, M.D., et al., Plaintiffs-Appellees, v. Cowen & Company, Defendant-Appellant. 03-3112 Dominic A. Visconsi, Sr., et al., Plaintiffs-Appellees, v. Lehman Brothers, Inc.; Lehman Brothers Holdings, Inc., Defendants-Appellants. No. 03-3113 Dominic A. Visconsi, Sr., et al., Plaintiffs-Appellees, v. S.G. Cowen Securities Corporation; Societe Generale, Defendants-Appellants.

Nos. 02-3820/02-3821/02-3822/02-3823/02-3824/ 02-3825/02-3826/02-3867/02-3868/02-3869/02-3870/ 02-3873/02-3874; 03-3041/03-3042/03-3043/03-3045/ 03-3112/03-3113/03-3258

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

340 F.3D 386; 2003 U.S. App. LEXIS 16588; 2003 FED App. 0284P (6th Cir.)

June 17, 2003 Argued
August 13, 2003, Decided
August 13, 2003, Filed.

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**JUDGES:** Before: NORRIS, DAUGHTREY, and ROGERS, Circuit Judges.

**OPINION BY:** ALAN E. NORRIS

**OPINION:**

ALAN E. NORRIS, Circuit Judge. This dispute arises from a massive fraud in which Frank Gruttadauria, a Cleveland stockbroker, misappropriated at least $54 million of his clients' money. The plaintiffs, all clients of Gruttadauria, brought this action against the brokerage houses for which he worked over the course of his career. The defendants moved to stay the proceedings and compel arbitration pursuant to arbitration clauses in the account agreements. The district court, relying largely on the gross nature of the fraud, ruled that the arbitration clauses in the agreements did not apply to the dispute and set the case for trial. The defendants appeal this decision. Thus, the only question of law in this interlocutory appeal is whether similarly worded arbitration clauses in the plaintiffs' brokerage account agreements mandate arbitration of their claims.

I

Frank Gruttadauria was a stockbroker for the defendant brokerage houses or firms that were purchased by them. As early as 1987, Gruttadauria began to send falsified statements to his clients that significantly overstated the

value of their accounts. Gruttadauria had incurred significant losses in some of these accounts, and he falsified statements to cover this up.

To make good when clients requested withdrawals from their inflated accounts, Gruttaduaria either used new deposits by other clients or withdrew funds from other clients' accounts to make payments. In a separate criminal proceeding against him, Gruttaduaria entered into a plea agreement in which he admitted taking $54 million in "unauthorized withdrawals" between 1996 and 2002 alone. He also admitted that he gained at least $1 million personally from the fraud.

Gruttaduaria's scheme eventually collapsed. According to the plea agreement, by 2001 Gruttadauria's clients' accounts had a paper value of $278 million, while their actual value was only $1.8 million. Gruttadauria fled after leaving a letter of confession. In the letter, he claimed that he was the only person involved in the scheme but implied that the brokerage houses were grossly negligent for not monitoring his activities. He later surrendered to authorities and pleaded guilty to a multi-count federal indictment.

Plaintiffs brought this action against defendants alleging numerous securities law violations including outright theft from their accounts. Most plaintiffs also allege churning, unauthorized trading, and excessive risk taking as well as a number of other common law and statutory claims. In denying the defendants' motions to stay the proceedings and compel arbitration, the district court did not provide a separate analysis for each arbitration agreement. However, the parties agree that each contains roughly the same language. The typical arbitration clause in

the account agreements reads, "Any controversy arising out of or relating to any of my accounts, to transactions with you for me, or to this or any other agreement or the construction, performance or breach thereof, shall be settled by arbitration."

The district court held that the arbitration clauses were not binding because, given the nature of the fraud, the agreements were void *ab intitio* [sic] and there were effectively no accounts. In the alternative, the district court held that the fraud alleged here was not covered by the arbitration clauses. We reverse the district court and remand with instructions to consider the particular claims of the parties regarding the validity of the arbitration clauses standing apart from the account agreements as a whole.

## II

We have jurisdiction over this interlocutory appeal under 9 U.S.C. § 16(a)(1), which provides that an appeal may be taken from an order refusing to compel arbitration or refusing to stay an action pending arbitration. We review a district court's denial of these motions *de novo*. *Burden v. Check into Cash of Kentucky, L.L.C.*, 267 F.3d 483, 487 (6th Cir. 2001); *Stout v. J.D. Byrider*, 228 F.3d 709, 714 (6th Cir. 2000).

### A. *Federal Arbitration Act*

The Federal Arbitration Act ("FAA") provides that arbitration clauses in commercial contracts "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. If a court determines that the cause of action

is covered by an arbitration clause, it must stay the proceedings until the arbitration process is complete. 9 U.S.C. § 3. In order to compel arbitration, a court must conduct a hearing, and:

> upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement. . . . If the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to the trial thereof.

9 U.S.C. § 4.

Under the statute, a district court must make a number of threshold determinations before compelling arbitration:

> When considering a motion to stay proceedings and compel arbitration under the Act, a court has four tasks: first, it must determine whether the parties agreed to arbitrate; second, it must determine the scope of that agreement; third, if federal statutory claims are asserted, it must consider whether Congress intended those claims to be nonarbitrable; and fourth, if the court concludes that some, but not all, of the claims in the action are subject to arbitration, it must determine whether to stay the remainder of the proceedings pending arbitration.

228 F.3d at 714.

It is a well-established rule that any doubts regarding arbitrability should be resolved in favor of arbitration. *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460

U.S. 1, 24-25, 74 L. Ed. 2d 765, 103 S. Ct. 927 (1983). In addition, the Supreme Court has held that the FAA preempts state laws and policies regarding arbitration. *Southland Corp. v. Keating*, 465 U.S. 1, 10-11, 79 L. Ed. 2d 1, 104 S. Ct. 852 (1984). State contract law, however, governs in determining whether the arbitration clause itself was validly obtained, provided the contract law applied is general and not specific to arbitration clauses. *Doctor's Assocs. v. Casarotto*, 517 U.S. 681, 686-87, 134 L. Ed. 2d 902, 116 S. Ct. 1652 (1996); *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 944, 131 L. Ed. 2d 985, 115 S. Ct. 1920 (1995); *Great Earth Cos. v. Simons*, 288 F.3d 878, 889 (6th Cir. 2002).

The leading Supreme Court case dealing with fraud and arbitration agreements is *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*, 388 U.S. 395, 18 L. Ed. 2d 1270, 87 S. Ct. 1801 (1967). There, the Supreme Court held that a "claim of fraud in the inducement of the entire contract" is a matter to be resolved by the arbitrators, not the federal courts. *Id.* at 402-04. However, if there was a fraud that "goes to the 'making' of the agreement to arbitrate," then a federal court may adjudicate. *Id.* at 403-04. In so holding, the Court relied on the explicit statutory language of section 4 of the FAA:

> Under [section] 4, with respect to a matter within the jurisdiction of the federal courts save for the existence of an arbitration clause, the federal court is instructed to order arbitration to proceed once it is satisfied that 'the making of the agreement for arbitration or the failure to comply (with the arbitration agreement) is not in issue.' Accordingly, if the claim is fraud in the inducement of the arbitration clause itself – an issue which goes to the 'making' of the agreement

> to arbitrate – the federal court may proceed to adjudicate it. . . . We hold, therefore, that in passing upon a [section] 3 application for a stay while the parties arbitrate, a federal court may consider only issues relating to the making and performance of the agreement to arbitrate.

*Id.* (footnotes omitted). Thus, even if there was fraudulent inducement to sign the contract as a whole, by the terms of sections 3 and 4 of the FAA, the arbitration clause is severable and will only be voided for fraudulent inducement in its making. *See also Ferro Corp. v. Garrison Indus.*, 142 F.3d 926, 933 (6th Cir. 1998) ("The Supreme Court has held that once a court determines that the agreement to arbitrate has not been fraudulently induced, all other issues falling within that agreement are to be sent to arbitration.") (citing *Prima Paint* at 403-04).

This basic analysis does not change when applied to securities fraud claims. In *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 96 L. Ed. 2d 185, 107 S. Ct. 2332 (1987), the Supreme Court rejected an attempt to carve out an exception for Securities and Exchange Act violations. In doing so, the Court specifically approved the arbitration procedures of the New York Stock Exchange, the American Stock Exchange, and the NASDAQ, which are the arbitration for a specified in the account agreements at issue here. *Id.* at 233-34.

B. *Validity of the Arbitration Agreements in Light of the Fraud*

Before a court can send a case to arbitration, it must first determine that a valid agreement to arbitrate exists. 9 U.S.C. § 2; *Stout*, 228 F.3d at 714. An arbitration agreement may be invalidated for the same reasons for which

any contract may be invalidated, including forgery, unconscionability, and lack of consideration. *Casarotto*, 517 U.S. at 687. "Ordinary state-law principles that govern the formation of contracts" will apply to this analysis. *First Options*, 514 U.S. at 944.

The district court held that, because the money in the accounts was largely stolen and Gruttadauria had no intention of acting as a true broker for the plaintiffs, no account agreements really existed, thus making the agreements void *ab initio* and invalidating the arbitration clauses. Memorandum of Opinion, July 19, 2002 at 7. The district court distinguished *Prima Paint*, arguing that it was not applicable to "challenges to the very existence of the contract on the grounds that there was never an agreement at all." *Id.* In addition, the district court held that because of the theft there were no "accounts," and hence the account agreements are unenforceable. *Id.* at 7-8.

This reasoning is not consistent with two cases from this court that enforced arbitration clauses in securities fraud cases. *Arnold v. Arnold Corp.-Printed Communications For Bus.*, 920 F.2d 1269 (6th Cir. 1990); *C.B.S. Employees Fed. Credit Union v. Donaldson, Lufkin and Jenrette Sec. Corp.*, 912 F.2d 1563 (6th Cir. 1990).

In *Arnold*, we held that, in order to void an arbitration clause, the complaint must contain a "well-founded claim of fraud in the inducement of the arbitration clause itself, *standing apart from the whole agreement*, that would provide grounds for the revocation of the agreement to arbitrate." *Id.* at 1278; *Great Earth*, 288 F.3d at 890 (quoting *Arnold*). In addition, we noted that, under *Prima Paint*, allegations of fraudulent schemes are "no longer

sufficient to overcome the strong federal policy in favor of arbitration." *Arnold*, 920 F.2d at 1281.

In *C.B.S. Employees*, the defendant brokerage house allegedly engaged in a large volume of unauthorized trades that resulted in substantial losses to an employees' credit union. The credit union brought an action alleging violations of federal and state securities laws, as well as the Racketeer Influenced and Corrupt Organizations Act ("RICO"). We rejected the argument that the underlying fraud voided the arbitration agreements and held that "the central issue, reduced to its simplest, is whether [plaintiff's] claim of fraud relates to the making of the arbitration agreement." *Id.* at 1566.

This court reinforced these rules recently in *Burden*, a case involving consumer fraud in a check cashing/loan scheme in which the true interest rate was allegedly over 500% that which was stated in the loan agreements. *Burden*, 267 F.3d at 486-87. In addition to the fraud, the defendants had also allegedly failed to obtain the proper state loan licenses. *Id.* at 489. Under the Kentucky law applied in *Burden*, loan agreements made without a license or in violation of certain other provisions of state law are void by statute. *Id.* at 490. The court concluded that the contract may well be void and rife with fraud, but these facts do not void the arbitration clause, which must be analyzed independently.[1] *Id.* at 490, 492.

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[1] Some of the plaintiffs assert that the criminal conduct alleged voids the arbitration clause. However, claims that, if true, amount to criminal behavior under RICO and antitrust laws have been held arbitrable by the Supreme Court. *See Shearson/American Exp., Inc. v. McMahon*, 482 U.S. at 239-240. In addition, all parties and the district court seem to agree that churning is arbitrable. Memorandum of

(Continued on following page)

The district court also found that, given the theft, no accounts existed and that this invalidated the arbitration clauses. This legal conclusion, however, conflicts with the holding of an intervening case decided by this court. In *Javitch v. First Union Securities, Inc.*, 315 F.3d 619, 628 (6th Cir. 2003), we rejected the argument that arbitration clauses were void because of a fraudulent account and instead focused on the validity of the arbitration clauses standing alone.

In sum, when claims involve "the validity of the contract as a whole" and not just the arbitration agreement, "such claims are to be brought before the arbitrator, not the district court in deciding a petition to compel arbitration." *Great Earth*, 288 F.3d at 892 (citing *Prima Paint*, 388 U.S. at 404); *see also Burden*, 267 F.3d at 491.

C. *Scope of the Arbitration Agreements*

District courts have the authority to decide, as a threshold matter, whether an issue is within the scope of an arbitration agreement. *Stout*, 228 F.3d at 714. A proper method of analysis here is to ask if an action could be maintained without reference to the contract or relationship at issue. If it could, it is likely outside the scope of the arbitration agreement. *Ford v. NYLCare Health Plans of Gulf Coast, Inc.*, 141 F.3d 243, 250-51 (5th Cir. 1998) (applying Texas arbitration law under a choice of law provision). Torts may often fall into this category, but

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Opinion, July 19, 2002 at 12-13. Churning, however, is a criminal act. *See, e.g., United States v. Trask*, 143 F. Supp. 2d 88, 89 (D. Mass. 2001) (discussing a 15-month prison sentence for a conviction under Securities and Exchange Act based solely on churning).

merely casting a complaint in tort does not mean that the arbitration provision does not apply. *Fyrnetics (Hong Kong) Ltd. v. Quantum Group, Inc.*, 293 F.3d 1023, 1030 (7th Cir. 2002). Even real torts can be covered by arbitration clauses "if the allegations underlying the claims 'touch matters' covered by the [agreement]." *Genesco, Inc. v. T. Kakiuchi & Co., Ltd.*, 815 F.2d 840, 846 (2d Cir. 1987). We are, however, aware of the Supreme Court's warning against "forcing unwilling parties to arbitrate a matter they reasonably would have thought a judge, not an arbitrator, would decide." *First Options*, 514 U.S. at 945.

The district court held in the alternative that the allegations of theft placed the dispute outside the scope of the arbitration provision by reasoning as follows:

> Generally, the underlying basis for the Plaintiffs' claims is Gruttadauria's alleged theft of their assets. . . . Conduct amounting to theft is so beyond what is expected from a broker that such conduct could not have been within the reasonable contemplation of the Plaintiffs when they signed the alleged account agreements.

Memorandum of Opinion, July 19, 2002 at 8-9.

However, it is evident that the fraudulent activities were a violation of the account agreements and arose out of activities contemplated by those agreements – the sale and purchase of securities and the management of accounts. The lawsuit by necessity must describe why Gruttadauria was in control of the plaintiffs' money and what the brokerage houses' obligations were. The plaintiffs therefore cannot maintain their action without reference to the account agreements, and accordingly, this action is covered by the arbitration clauses.

Plaintiffs claim that Gruttadauria's outrageous conduct was unforeseeable, and hence they could not have anticipated arbitrating such claims. However, it is far from clear that the conduct here was unforeseeable. Aggregating the losses of all the parties, as the plaintiffs frequently do, leads to a shocking total loss. But analyzed individually, it is foreseeable that churning, unauthorized risk taking, and illegal transfers to third parties could destroy the value of an individual account.

Furthermore, the arbitration agreements are quite broad: "Any controversy arising out of or relating to any of my accounts, to transactions with you for me, or to this or any other agreement or the construction, performance or breach thereof shall be settled by arbitration." We take the arbitration agreements at their word, and hold that any dispute arising out of (or that must make reference to) the agreements, accounts, or transactions conducted by the defendants is subject to arbitration.

The district court itself noted that churning, unauthorized trading, and excessive risk-taking are clearly foreseeable problems in a brokerage account and are encompassed by the arbitration agreement. Memorandum of Opinion, July 19, 2002 at 12-13. Most of the parties here allege churning, unauthorized trading, and excessive risk-taking in addition to alleging outright theft, and all parties allege either negligent hiring or violation of explicit or implied contracts. Under the district court's own analysis, those claims should have been given to an arbitrator. *See Stout*, 228 F.3d at 714 ("If the court concludes that some, but not all, of the claims in the action are subject to arbitration, it must determine whether to stay the remainder of the proceedings pending arbitration.") In addition, the churning, excessive risk-taking,

and unauthorized trading claims were part of the same fraudulent scheme and at the very least create doubts about the arbitrability of the theft claims, which should have been resolved in favor of arbitration as the Supreme Court directed in *Cone Memorial Hospital*.

D. *Mutuality of Obligation*

The Supreme Court has held that, under the FAA, state law contract defenses such as fraud, duress, and unconscionability may be applied by courts to invalidate arbitration agreements. *Casarotto*, 517 U.S. at 687. Mutuality has been included in that list as well. *Burden*, 267 F.3d at 491 (quoting *Matterhorn, Inc. v. NCR Corp.*, 763 F.2d 866, 868 (7th Cir. 1985)). This circuit has previously refused to compel arbitration on the grounds that an arbitration clause lacked mutuality when an arbitration service chosen by an employer retained the right to modify its rules without the employee's consent. *Floss v. Ryan's Family Steak Houses, Inc.*, 211 F.3d 306, 315-16 (6th Cir. 2000) (applying Kentucky and Tennessee law).

Plaintiffs argue that the arbitration agreements here lack mutuality because of the extensive self-help remedies in the account agreements that permit the defendants to seize the accounts of the plaintiffs for basically any breach of the account agreement. They argue that the defendants would never have to arbitrate a claim given this self-help provision, and therefore the clauses are unenforceable because there is no mutuality of obligation. The main case cited to support this notion is a California case, *Flores v. Transamerica HomeFirst, Inc.*, 93 Cal. App. 4th 846, 113 Cal.Rptr.2d 376 (Ct. App. 2001). There, a California appeals court held that the right of HomeFirst to foreclose

prior to or during arbitration made the arbitration provisions "unconscionable." *Id.* at 382. To be enforceable, the court held that the arbitration agreement must at least contain a "modicum of bilaterality." *Id.*

Ohio law applies here, and there is no indication that Ohio courts have adopted the California rule. On the contrary, an Ohio Appeals Court recently held that mutuality is not a requirement of a valid arbitration clause if the underlying contract is supported by consideration. *Joseph v. M.B.N.A. Am. Bank, N.A.*, 148 Ohio App. 3d 660, 664, 2002 Ohio 4090, 775 N.E.2d 550, 553 (2002). This appears to be the general trend. *See Harris v. Green Tree Fin. Corp.*, 183 F.3d 173, 179-80 (3rd Cir. 1999) (collecting cases and concluding that mutuality of obligation is generally satisfied in arbitration agreements if the underlying contract is supported by consideration). There is no doubt here that the underlying contract was supported by consideration.

In addition, plaintiffs cannot rely on this court's limited holding in *Floss*. We distinguished *Floss* in *Morrison v. Circuit City Stores, Inc.*, 317 F.3d 646 (6th Cir. 2003) (en banc), while applying Ohio law. The employment contract at issue in *Morrison* provided that only the employee's claims were subject to arbitration and that the employer, with thirty days notice provided on a specified day, could alter the terms of the arbitration agreement. *Id.* at 667. While noting that the mutuality requirement of an arbitration clause is not settled law in Ohio, *Morrison* held that the notice provision was sufficient consideration to preserve mutuality and upheld the arbitration clause. *Id.* at 668. The fact that only one party was bound by the arbitration agreement was not a concern.

While it is true that the self-help provisions give the brokerage house an upper hand, the arbitration provisions cover "any dispute," not just disputes in which the brokerage houses are defendants. Thus, by the contract's terms, the clients have as much a right to force arbitration as the brokerage houses. The right of self help may make this occurrence unlikely, but as *Morrison* and *Joseph* demonstrate, the chance that it may happen is sufficient under Ohio law to preserve mutuality. We therefore hold that, assuming mutuality of obligation in the arbitration clause is a requirement under Ohio law, the arbitration clauses here easily satisfy that requirement.

E. *Issues Specific to Individual Arbitration Agreements*

Because some parties raise issues specific to their arbitration agreements and because the record below is undeveloped in this regard, we are unable to conclude whether the arbitration agreements here are valid. "[A] well-founded claim of fraud in the inducement of the arbitration clause itself, *standing apart from the whole agreement*" may invalidate an arbitration clause, and district courts are authorized to make threshold rulings in this regard. *Arnold*, 920 F.2d at 1278.

It is firmly established that an arbitration clause obtained by forgery is not valid. *See, e.g., Burden*, 267 F.3d at 488; *Three Valleys Mun. Water Dist. v. E.F. Hutton & Co.*, 925 F.2d 1136, 1140 (9th Cir. 1991). Some plaintiffs have claimed that signatures on account agreements were forged, and Gruttadauria is a confessed forger. In addition, there are other valid concerns, such as whether a trust was bound by the signature of its trustee on separate accounts containing arbitration agreements and signed in

an individual capacity. It is well-established that a lack of signatory power can invalidate an arbitration clause. *See, e.g., Burden*, 267 F.3d at 489-90.

We cannot reach these fact-intensive issues, and we therefore "remand Plaintiffs' allegations that the arbitration agreements, separate from the loan agreements, are not enforceable against them on 'grounds as exist at law or in equity for the revocation of any contract.'" *Burden*, 267 F.3d at 493 (quoting 9 U.S.C. § 2 and *Casarotto*, 517 U.S. at 683.) In making this determination, the district court is bound by this court's previous directives to district courts in *Great Earth* and *Javitch*. *Great Earth* requires that, to invalidate the arbitration clauses, "the evidence presented [must be] such that a reasonable finder of fact could conclude that no valid agreement to arbitrate exists." 288 F.3d at 889. *Javitch* specifies that "before compelling an unwilling party to arbitrate, the court must engage in a limited review to determine whether the dispute is arbitrable; meaning that a valid agreement to arbitrate exists between the parties." 315 F.3d at 624 (emphasis added).

III

For the foregoing reasons, the judgment of the district court is reversed, and this cause is remanded for a determination of whether the arbitration clauses, analyzed independently from the account agreements, are valid.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

| | | |
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| SAMUEL GLAZER,<br><br>Plaintiff,<br><br>vs.<br><br>LEHMAN BROTHERS, INC., et al.,<br><br>Defendants. | ) | CASE NO. 1:02CV370<br><br>Judge John M. Manos<br><br>MEMORANDUM OF OPINION |

On August 13, 2003, the Sixth Circuit reversed this Court's decision that the arbitration clauses at issue are invalid. In addition, the Sixth Circuit remanded the case for this Court to consider the Plaintiff's claim "of fraud in the inducement of the arbitration clause itself, apart from the whole agreement". *See Fazio v. Lehman Brothers. Inc.*, 340 F.3d 386, 397 (6th Cir. 2003).

For the following reasons, the Court rules that Plaintiff Glazer's claims are not subject to arbitration.

## I. FACTS

This action arises out of the conduct of Frank Gruttadauria, who formerly acted as an investment broker for Samuel Glazer. Gruttadauria pled guilty to criminal charges arising out of his theft of assets from investment accounts he was servicing over a period of approximately fifteen years, and covering up his activity by providing false account statements. The Plaintiff is one of his victims.

On February 28, 2002, the Plaintiff brought suit against the brokerage firms for which Gruttadauria worked over the period of the alleged theft. The brokerage defendants include Lehman Brothers, Inc. and certain affiliated companies (collectively "Lehman"), and SG Cowen Securities Corp. and its parent Societe Generale (collectively "SG Cowen"). The Plaintiff asserts that the brokerages are liable for Gruttadauria's conduct, and brings fraud claims under the federal securities laws, including Section 10(b) of the Securities and Exchange Act of 1934 (15 U.S.C. § 78j(b)) and S.E.C. Rule 10(b)(5), as well as related claims under state law.

The Defendants assert that the Plaintiff executed various agreements governing his brokerage accounts serviced by Gruttadauria. These agreements allegedly contain broad arbitration clauses that require all disputes arising out of account activity to be resolved through arbitration. In response to the Plaintiff's complaint, the Defendants each filed a motion to compel arbitration.

On July 19, 2002, the Court denied the Defendants' motions to compel arbitration as to Glazer's action, as well as the actions of other investors who had brought similar cases. The Court held as to all cases that there was no meeting of the minds with respect to any portion of the alleged account agreements, including the arbitration provisions, and that claims arising from allegations of outright theft are beyond the scope of such arbitration provisions. On August 13, 2003, the Sixth Circuit reversed, but noted that "some parties raise issues specific to their arbitration agreements". *Fazio v. Lehman Brothers, Inc.*, 340 F 3d 386, 397 (6th Cir. 2003). Accordingly, the Sixth Circuit remanded the actions for this Court to consider

"whether the arbitration clauses, analyzed independently from the account agreements, are valid." *Id.* at 398.

On September 3, 2003, the Court held a hearing with respect to the Plaintiff's allegations of fraudulent inducement of the arbitration clauses independent and apart from the account agreements as a whole. Three witnesses testified at the hearing. The first witness was Terry McHugh, an attorney, CPA, and registered investment counselor who advised the Plaintiff with respect to investment matters from about 1988 to 1999. The Plaintiff also testified. The third witness, called by Defendant Lehman, was Jonathan Morrs. He testified as to the acquisition of accounts of SG Cowen by Lehman in October 2000.

The Plaintiff asserts that, during a conversation in his office with Gruttadauria, the Plaintiff refused to sign any account documents containing an arbitration clause. Gruttadauria told him that the arbitration clauses were a formality required by SG Cowen to open an account, but as manager and head of the Cleveland office, he promised the Plaintiff that the clauses would never be enforced as to him. Based on Gruttadauria's promise, the Plaintiff signed the account documents. The Plaintiff alleges that Gruttadauria made the promise not to enforce the arbitration clauses solely to obtain access to the Plaintiff's money without any intention of ever fulfilling the promise. Accordingly, the Plaintiff was fraudulently induced to sign the account documents with the arbitration clauses in tact.

The Plaintiff testified that despite his business experience, he had little direct investment experience. He always relied on others on matters of investment. McHugh acted as the Plaintiff's investment advisor from about July

1988 through some time in 1999. Roughly 20 to 25 per cent of the Plaintiff's investments were in equities, and the rest were in bonds, treasury bills, and other fixed income investments. McHugh testified that with respect to accounts containing equities, their preference was not to sign account agreements containing arbitration clauses. They would do so as to the non-equity accounts because there was generally minimal trading, and would do so as to equity accounts when either the trading activity was minimal and/or the asset value involved was insignificant as compared to the Plaintiff's total net worth. Indeed, the record reflected various times at which McHugh and the Plaintiff acquiesced to arbitration clauses, but they explained these accounts as involving fixed income investments, minimal trading activity, relatively insignificant asset value, or other special circumstances. (Tr. at 17-19, 23-25, 36-37, 42-48, 71-74, 95-101.)[1]

Sometime in 1994 or 1995, McHugh initiated contact with a broker named David Tissue at Cowen & Company, a predecessor to Defendant SG Cowen. Despite several requests from Tissue, the Plaintiff, acting through McHugh, refused to sign any account agreement or application containing an arbitration clause. Later, however, in 1996 the Plaintiff signed an "Options Agreement" with respect to the Tissue account The Options Agreement represents that the Plaintiff has ten years experience with options at an approximate cost of $50,000 per option. It also states that the Plaintiff was sixty years old at the time, McHugh and the Plaintiff testified that these representations were inaccurate, and that at most only a single

[1] References to the transcript, "Tr." refer to the transcript of the hearing held on September 3, 2003.

options transaction was ever made with respect to the Tissue account. The sole options transaction occurred around the time the Options Agreement was signed to permit the transaction. (Tr. at 28-32, 37-38, 63-64, 74-75, 83-84.)

In 1998, the Plaintiff was referred to Gruttadauria by two acquaintances, Dominic Visconsi, Sr., a prominent real estate developer, and James Stanton, an attorney and former Congressman. They recommended Gruttadauria to the Plaintiff as a talented broker. Gruttadauria advised the Plaintiff to give him control over the assets then in the Tissue account, and the Plaintiff complied. A new account was created to be managed by Gruttadauria. (Tr. at 75-78.)

Gruttadauria sent the Plaintiff three documents to sign with respect to the new account to be opened and managed by Gruttadauria: an account agreement, a margin agreement, and an options agreement. A fourth document was sent, which was an account agreement for the original Tissue account which Gruttadauria claimed was not on file. All four documents contained the broad arbitration clauses at issue. At first, the Plaintiff refused to sign the account documents because of the presence of the arbitration clauses. After his refusal, the two men met at the Plaintiff's office. The Plaintiff testified that Gruttadauria promised him, as managing director of the Cleveland office of SG Cowen, that the arbitration clauses would not be enforced against him. He further told the Plaintiff that his clients were making a lot of money, and so quick action was necessary if the Plaintiff wished to participate. In reliance on the promise not to enforce the arbitration clauses, the Plaintiff signed the account documents within a couple days after their meeting, and then gave the

documents to McHugh to return them. (Tr. At 78-82, 121-23.)

Despite advising the Plaintiff with respect to most investment matters, McHugh had no involvement with respect to the investments with Gruttadauria. McHugh's sole involvement was to send the signed account documents to Gruttadauria, but McHugh did not review them, and did not discuss them with either Gruttadauria or the Plaintiff. (Tr. at 32-34, 39, 49-51, 83, 119-23.)

Gruttadauria never invested the Plaintiff's money. Instead, he absconded with the funds and used them to pay withdrawal requests of other clients and for his own personal benefit. The Sixth Circuit relied on Gruttadauria's criminal proceedings, stating:

> As early as 1987, Gruttadauria began to send falsified statements to his clients that significantly overstated the value of their accounts. Gruttadauria had incurred significant losses in some of these accounts, and he falsified statements to cover this up. To make good when clients requested withdrawals from their inflated accounts, Gruttadauria either used new deposits by other clients or withdrew funds from other clients' accounts to make payments. In a separate criminal proceeding against him, Gruttadauria entered into a plea agreement in which he admitted taking $54 million in "unauthorized withdrawals" between 1996 and 2002 alone. He also admitted that he gained at least $1 million personally from the fraud.

*Fazio*, 340 F.3d at 391.

The Plaintiff alleges that there was fraudulent inducement as to the arbitration clauses independent of the

account agreements as a whole. He argues that Gruttadauria promised that the arbitration clauses would never be enforced against him, but made such promise without the intention of performing. Instead, Gruttadauria sought only a signature to obtain the Plaintiff's money to further the criminal scheme.

## II. LAW AND ANALYSIS

The Sixth Circuit has remanded this case for the Court to consider the Plaintiff's allegations of fraudulent inducement of the arbitration clauses independent and apart from the account agreements as a whole. As stated in *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*, 388 U.S. 395 (1967):

> if the claim is fraud in the inducement of the arbitration clause itself – an issue which goes to the 'making' of the agreement to arbitrate – the federal court may proceed to adjudicate it. But the statutory language does not permit the federal court to consider claims of fraud in the inducement of the contract generally. [Footnotes omitted.]

*Id.* at 403-04; *see also Great Earth Companies, Inc. v. Simons*, 288 F.3d 878, 889 (6th Cir. 2002); *Burden v. Check Into Cash of Kentucky, LLC*, 267 F.3d 483, 488 (6th Cir. 2001). The Court's consideration of a motion to compel arbitration is limited to determining whether the parties entered into a valid agreement to arbitrate. *Fazio*, 340 F.3d at 398, *citing*, *Javitch v. First Union Securities, Inc.*, 315 F.3d 619, 624 (6th Cir. 2003); *Burden*, 267 F.3d at 487; *CBS Employees Federal Credit Union v. Donaldson, Lufkin, and Jenrette Securities, Corp.*, 912 F.2d 1563, 1567 (6th Cir. 1990). State contract law applies to generally

applicable contract defenses to arbitration clauses, such as fraud. *Great Earth*, 288 F.3d at 889.

To show that the validity of an arbitration clause is in issue, the party opposing arbitration must demonstrate a genuine issue of material fact as to the agreement to arbitrate. Thus, the standard for deciding a motion to compel arbitration mirrors that for withstanding a motion for summary judgment. *Great Earth*, 288 F.3d at 889. To preclude arbitration, the evidence must be such that a reasonable fact finder could conclude that no valid agreement to arbitrate exists. *Fazio*, 340 F.3d at 398, *citing, Great Earth*, 288 F.3d at 889.

A. Parol Evidence Rule

The Plaintiff testified that Gruttadauria promised that the account agreements were mere formalities required by SG Cowen to create an account, but, as manager of the Cleveland office, the arbitration clauses would not be enforced as to him. The Plaintiff argues, therefore, that there was no valid agreement to arbitrate. The Defendants argue that the parol evidence rule bars any consideration of Gruttadauria's alleged oral promise.

The parol evidence rule provides that absent fraud, mistake, or other invalidating causes, prior or contemporaneous oral or written agreements may not be used to vary, contradict, or supplement an integrated written contract. The rule actually is not a rule of evidence, but a rule of substantive law that defines the limits of a contract. *Galmish v. Cicchini*, 90 Ohio St. 3d 22, 27 (2000); *Kashif v. Central State University*, 729 N.E.2d 787, 790 (Ohio App. 1999); *Watkins & Sons Pet Supplies v. Iams Co.*, 254 F.3d 607, 612 (6th Cir. 2001).

The parol evidence rule, however, does not preclude a party from introducing parol or extrinsic evidence of fraudulent inducement:

> Fraud cannot be merged; hence the doctrine, which is merely only another form of expression of the parol-evidence rule, that prior negotiations and conversations leading up to the formation of a written contract are merged therein, is not applicable to preclude the admission of parol or extrinsic evidence to prove that a written contract was induced by fraud. Stated differently, "[i]t was never intended that the parol evidence rule could be used as a shield to prevent the proof of fraud, or that a person could arrange to have an agreement which was obtained by him through fraud exercised upon the other contracting party reduced to writing and formally executed, and thereby deprive the courts of the power to prevent him from reaping the benefits of his deception or chicanery." [Citations omitted.]

*Galmish*, 90 Ohio St. at 28.

The Plaintiff argues that his testimony as to Gruttadauria's oral promise not to enforce the arbitration clause is admissible to show fraudulent inducement. The Defendants, however, argue that framing a claim as "fraudulent inducement" is impermissible if the parol evidence simply contradicts an unambiguous writing.

The Plaintiff relies on cases holding that the parol evidence rule does not bar a party from showing that a writing was not actually intended to be an agreement: "the parol evidence rule does not preclude a party from showing that a writing which apparently constitutes a contract, was not intended or understood by either party to be

binding upon them." *F.W. Dodge Corp. v. Fultz*, 175 N.E.2d 543, 546 (Ohio App. 1961). In *F.W. Dodge*, the Plaintiff brought suit for payment for the remainder of a subscription for a business bulletin. The written contract provided that the subscription was for one year, but the Defendant asserted that he signed only on the Plaintiff's oral assurance that he could cancel after six months. The Court rejected the Plaintiff's reliance on the parol evidence rule, and concluded that the Defendant's testimony as to conversations with the Plaintiff was admissible to show that there was no intent to be bound by the writing. *Id.*

Similarly, in *National City Bank Akron v. Donaldson*, 642 N.E.2d 58 (Ohio App. 1994), the Defendant co-signed a car loan for her son, and the bank sued her for the unpaid portion. The Defendant submitted an affidavit stating that she co-signed the loan agreement only after the car salesman assured her that she would never have to make any payments. The Court concluded that the parol evidence rule did not preclude consideration of the affidavit.

> A different situation is presented, however, when one of the parties to what appears on its face to be a "complete and accurate integration of [a] contract" argues that *the parties agreed that the document would not be an expression of an agreement between them*. In that situation, the parol evidence rule has no application until the initial issue of whether the parties intended the proffered document to he an expression of their agreement has been resolved. Any otherwise admissible evidence is properly considered by a court in determining whether a proffered document was intended by the parties to be a "complete and accurate integration of [a] contract" between them . . . *It is well settled that whatever*

> *the formal documentary evidence, the parties to a legal transaction may always show that they understand a purported contract not to bind them;* it *may, for example, be a joke, or a disguise to deceive others. It is no objection that such an understanding contradicts the writing; a writing is conclusive only so far as the parties intend it to be the authoritative memorial of the transaction.* [Citations omitted.]

*Id.* at 60-61 (emphasis added).

In *Great Earth Companies, Inc. v. Simons*, 2000 WL 310354 (S.D.N.Y. March 24, 2000), *opinion partially withdrawn on other grounds*, 2000 WL 640829, (S.D.N.Y. May 18, 2000), the court concluded that there was fraudulent inducement as to an arbitration clause. The contract called for arbitration in New York. However, the Plaintiffs asserted that they relied on assurances in an offering circular that, as Michigan residents, they would not be forced to arbitrate outside of Michigan. The Court found fraudulent inducement based on misrepresentations in the offering circular, and further stated that the fraud allegations rendered parol evidence admissible. *Id.* at *4 and footnote 3: The Sixth Circuit relied on this conclusion in related litigation over arbitration in Michigan. *See Great Earth Companies, Inc. v. Simons*, 288 F.3d 878, 890 (6th Cir. 2002) ("In the instant case there is no question that Great Earth fraudulently induced the Simonses to agree to the arbitral forum selection clause contained in Article 15.3, which provides that arbitration of disputes take place in New York.")

The Plaintiff argues that under *Prima Paint*, the arbitration provisions are considered separate and distinct contracts. Accordingly, parol evidence is admissible on the

issue of whether Gruttadauria and the Plaintiff intended to be bound by the arbitration provisions.

On the other hand, the Defendants rely on cases that stand for the proposition that a claim of fraudulent inducement cannot be used to contradict the terms of a signed writing.

> However, the parol evidence rule may not be avoided "by a fraudulent inducement claim which alleges that the inducement to sign the writing was a promise, the terms of which are directly contradicted by the signed writing. Accordingly, an oral agreement cannot be enforced in preference to a signed writing which pertains to exactly the same subject matter, yet has different terms." . . . In other words, "[t]he Parol Evidence Rule will not exclude evidence of fraud which induced the written contract. But, a fraudulent inducement case is not made out simply by alleging that a statement or agreement made prior to the contract is different from that which now appears in the written contract. Quite to the contrary, attempts to prove such contradictory assertions is exactly what the Parol Evidence Rule was designed to prohibit. [Citations omitted.]

*Galmish*, 90 Ohio St. 3d at 29; *see also Citicasters Co. v. Brickler & Eckler, LLP*, 778 N.E.2d 663, 666-67 (Ohio App. 2002); *National City Bank v. Facilities Asset Management, Inc.*, 762 N.E.2d 1060, 1064 (Ohio App. 2001); *Watkins*, 254 F.3d at 613. The parol evidence rule bars evidence of fraud unless the fraud arises independent from the terms of an integrated written agreement. *Galmish*, 90 Ohio St. 3d at 30; *Watkins*, 254 F.3d at 613; *Bollinger, Inc. v. Mayerson*, 689 N.E.2d 62, 69 (Ohio App. 1996).

The Defendants argue that the arbitration provisions are terms of the account agreements, which the Plaintiff admittedly signed. He cannot now offer parol evidence in contradiction of an explicit term in the written account agreements.

The distinction made in the two lines of cases cited by the parties is as follows. Under the cases of *F.W. Dodge*, *National City*, and *Great Earth*, if an issue arises as to whether parties intended to be bound by an alleged written contract, parol evidence is admissible to show that despite the writing, the parties did not intend to enter any agreement. Under the *Galmish* type cases, however, if the parties generally intended to be bound by a written agreement, parol evidence is inadmissible to directly contradict one of its terms. The parties essentially dispute which situation is present in the current case.

The Court agrees with the Plaintiff that the arbitration provisions must be treated as contracts separate and distinct from the broader account agreements. Therefore, parol evidence is admissible to show that the parties lacked the intent to be bound to the arbitration clauses despite the signed account agreements. "The Court in Prima Paint found that the arbitration clauses were 'separable' from the contracts in which they were included". *Burden v. Check Into Cash of Kentucky, LLC*, 267 F.3d 483, 488 (6th Cir. 2001); *see also Javitch v. First Union Securities, Inc.*, 315 F.3d 619, 627-28 (6th Cir. 2003). Ohio courts interpreting *Prima Paint*, applying it to Ohio contract law, have concluded likewise. "[P]roof of fraud in the inducement of the arbitration provision does itself defeat a motion to compel arbitration." *ABM Farms, Inc. v. Woods*, 81 Ohio St. 3d 498, 501 (1998). Ohio law mirrors federal law in its acknowledgment of the severability of the

arbitration clause from the remainder of the contract: "R.C. 2711.01 more generally acknowledges that an arbitration clause is, in effect, a contract within a contract, subject to revocation on its own merits." *ABM*, 81 Ohio St. 3d at 501.

Accordingly, the arbitration provisions must be viewed as distinct contracts subject to invalidity independent of the broader account agreements. Parol evidence, therefore, is admissible to show fraudulent inducement and/or a lack of intent to be bound by the arbitration clauses despite the signed account documents.[2] The Court may consider the Plaintiff's testimony regarding his conversations with Gruttadauria to determine whether there was a valid agreement to arbitrate.

The Court has reviewed the cases the Defendants deem similar to the current case, and concludes that such cases are not controlling. In *Paxon v. Asensio*, 2003 WL 21076984 (E.D. Pa. May 5, 2003), the plaintiff sought to avoid an arbitration clause on the ground that he was promised it was unenforceable. The court concluded that Pennsylvania's parol evidence rule, which is similar to Ohio's, barred evidence of the representation. The court in *Paxon*, however, ignored the requirement of *Prima Paint*,

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[2] The parties devote much of their briefing to the issue of whether the account agreements and/or arbitration provisions constitute integrated contracts. The issue of integration, however, is not relevant to the type of claims asserted by the Plaintiff. If the parties lacked the intent to be bound by a signed writing, parol evidence is admissible despite the existence of "what appears on its face to be a "complete and accurate integration of [a] contract". *National City*, 642 N.E.2d at 60-61. "[T]he presence of an integration provision does not vitiate the principle that parol evidence is admissible to prove fraud." *Galmish*, 90 Ohio St. 3d at 28.

as further applied in the Sixth Circuit and under Ohio law, that the arbitration agreement be treated as an independent contract, and not merely a term of the agreement in which it appears. This case, therefore, does not apply here.

In *McBride v. St. Anthony Messenger Magazine*, 2003 WL 1903381 (S.D. Ind. February 6, 2003), the Plaintiff claimed he was promised that the arbitration provision related only to choice of law. This ease is inapposite. First, the court characterized as "absurd" the position that only choice of law could be arbitrated. In addition, the plaintiff's challenge to the arbitration provision related to its scope, and not its existence. His argument merely sought to contradict a term of the arbitration agreement, and thus did not challenge the validity of the agreement to arbitrate in and of itself. The case, therefore, is distinguishable from the current case.

In *Snap-On Tools Corp. v. Vetter*, 838 F. Supp. 468, 471 (D. Mont. 1993), the plaintiff alleged that the arbitration provision was invalid because it was never discussed or explained. Similarly, in *Young v. Prudential Securities, Inc.*, 891 S.W.2d 843, 843-44 (Mo. App. 1995), the plaintiffs alleged that they did not read the arbitration provision and it was never explained. The courts correctly held that there was no duty of parties to explain contractual provisions in absence of an inquiry or fiduciary relationship. In the current case, in contrast, the arbitration clause was specifically discussed and Gruttadauria made affirmative misrepresentations as to whether it would be enforced against the Plaintiff.

Accordingly, the cases cited by the Defendants do not preclude this Court from considering the Plaintiff's

testimony challenging the validity of the arbitration clauses.

B. Fraudulent Inducement

To avoid arbitration, the Plaintiff must satisfy the elements of fraudulent inducement. Because he essentially seeks recission [sic] of written agreements, the proof must be by clear and convincing evidence. *Domo v. Stouffer*, 580 N.E.2d 788, 792 (Ohio App. 1989), *citing*, *Household Finance Corp. v. Altenberg*, 5 Ohio St. 2d 190, 192 (1966); *Funk v. Montgomery AMC/Jeep/Renault*, 586 N.E.2d 1113, 1118 (Ohio App. 1990).

The elements of fraud are: (1) a representation or, when there is a duty to disclose, concealment of a fact; (2) which is material to the transaction at hand; (3) made falsely, with knowledge of its falsity, or with such utter disregard and recklessness as to whether it is true or false that knowledge may be inferred; (4) with the intent of misleading another into relying upon it; (5) justifiable reliance upon the representation or concealment, and (6) a resulting injury proximately caused by the reliance. *Gaines v. Preterm-Cleveland*, 33 Ohio St. 3d 54, 55 (1987); *see also Davis v. Sun Refining and Marketing Co.*, 671 N.E.2d 1049, 1058 (Ohio App. 1996); *Lepera v. Fuson*, 613 N.E.2d 1060, 1063 (Ohio App. 1992).

Contractual obligations induced through fraud are void. *Hanes v. Giambrone*, 471 N.E.2d 801, 807-08 (Ohio App. 1984). "In order to prove fraud in the inducement, a plaintiff must prove that th defendant made a knowing, material misrepresentation with the intent of inducing the plaintiff's reliance, and that the plaintiff relied upon that

misrepresentation to her detriment." *ABM Farms, Inc. v. Woods*, 81 Ohio St. 3d 498, 502 (1998).

The Plaintiff testified that Gruttadauria promised not to enforce the arbitration provisions if he signed the account documents. Gruttadauria indicated that he had the sole authority to make that decision. The Court concludes that Gruttadauria's statement constitutes a material misrepresentation, satisfying the first two elements of fraud. With respect to the first element, a fraud claim usually must be predicated upon a false representation of past or present fact. However, a promise as to future conduct can be the basis of a fraud claim if the promisor had no intention of performing at the time the promises were made. *Kasuri v. St. Elizabeth Hospital Medical Center*, 897 F.2d 845, 851-52 (6th Cir. 1990); *Snell v. Salem Avenue Associates*, 675 N.E.2d 555, 568 (Ohio App. 1996); *Greenstreet v. Bickers*, 647 N.E.2d 214, 217 (Ohio App. 1994).

The Defendants first dispute the Plaintiff's claim that he refused to sign the account agreements because of the arbitration clauses. The parties devote substantial argument to the Plaintiff's past practice with regard to arbitration clauses, relying on his relationships with numerous brokerages and a variety of investment classes. The Court deems the evidence of past practice with other brokerages to be irrelevant.

The Court concludes that the only relevant evidence of past practice relates to the Tissue account opened with Cowen & Company, the predecessor to Defendant SG Cowen. There is no dispute that the Plaintiff, on more than one occasion, refused to sign an account agreement for the Tissue account (Plaintiff's Exs. 2 and 3.) Indeed, to

ensure complete documentation, Gruttadauria required the Plaintiff to sign an agreement for the Tissue account even though the new Gruttadauria account was to contain all of the Plaintiff's assets. These facts support the Plaintiff's claim that he initially refused to sign the Gruttadauria account documents because of the arbitration clauses, and that enforcement of the arbitration clauses was a material matter. Therefore, the first two elements of fraud are satisfied.

The third and fourth elements of fraud require that Gruttadauria's representations were made falsely and with the intent to mislead. Circumstantial evidence demonstrates Gruttadauria's fraudulent intent. The elements of fraud, including intent, can be proven by circumstantial evidence. *See Davis*, 671 N.E.2d at 1049; *AMF, Inc. v. Computer Automation, Inc.*, 573 F. Supp. 924, 933 (S.D. Ohio 1983).

The Sixth Circuit stated in connection with this case:

> As early as 1987, Gruttadauria began to send falsified statements to his clients that significantly overstated the value of their accounts. Gruttadauria had incurred significant losses in some of these accounts, and he falsified statements to cover this up. To make good when clients requested withdrawals from their inflated accounts, Gruttadauria either used new deposits by other clients or withdrew funds from other clients' accounts to make payments. In a separate criminal proceeding against him, Gruttadauria entered into a plea agreement in which he admitted taking $54 million in "unauthorized withdrawals" between 1996 and 2002 alone.

*Fazio*, 340 F.3d at 391. Thus, by 1998, when the Plaintiff was introduced to Gruttadauria, his criminal scheme was over a decade old. He needed the Plaintiff's signature to open the account at issue, and he needed the Plaintiff's assets to further his criminal activities, particularly his need for new deposits to fund withdrawal requests. The only reasonable conclusion is that Gruttadauria falsely represented that the arbitration provisions would not be enforced to obtain access [sic] the Plaintiff's money to further his criminal activity. This evidence is sufficient to demonstrate the third and fourth elements of fraud.[3]

The fifth element of fraud is that the Plaintiff *justifiably* relied on Gruttadauria's misrepresentations. When determining whether reliance was justified, the Court considers the totality of the circumstances, including the nature of the transaction, the materiality of the misrepresentation, the relationship of the parties, and their respective knowledge and means of knowledge. *Renner v. Derin Acquisition Corp.*, 676 N.E.2d 151, 161 (Ohio App. 1996). Reliance is justified if the representation is reasonable on its face and there is no reason for doubt. *Crown Property*, 681 N.E.2d at 1349; *Lepera*, 613 N.E.2d at 1065. When one

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[3] Gruttadauria submitted an affidavit in which he explicitly states that he fraudulently induced the Plaintiff to sign the account documents. (*See* Plaintiff's Ex. 5.) He is still under criminal investigation by state authorities. He did not testify at the hearing because his criminal attorney indicated that he would assert his Fifth Amendment right against self-incrimination if called to testify. The Defendants dispute the admissibility of the affidavit. Although Gruttadauria is an "unavailable witness" under Fed. Evid. R. 804, the Defendants deny the affidavit is admissible under Rule 804(b)(1) or (3) because he was never subjected to cross examination about his affidavit. The Court concludes that the circumstantial evidence is sufficient to demonstrate Gruttadauria's fraudulent intent without reliance on the affidavit.

is put on notice as to any such doubt, there is a duty to exercise proper diligence to investigate the situation before relying. *Finomore v. Epstein,* 481 N.E.2d 1193, 1196 (Ohio App. 1984).

The Defendants argue there was no justifiable reliance because the Plaintiff was a sophisticated businessman. This argument lacks merit – sophistication in business is not equivalent to sophistication in investing. The evidence shows that the Plaintiff had skill and success in managing and operating several companies. However, he had little investment experience, particularly in the stock market, and relied on others for investment advice. Gruttadauria had a reputation as being a talented broker, so the Plaintiff's reliance on Gruttadauria for investment matters was justified despite the Plaintiff's business experience.

The Defendants also argue that the Plaintiff's reliance was not justified because he never sought advice from counsel or his investment advisor, Terry McHugh, as was his normal practice. This argument also lacks merit. The Plaintiff was introduced to Gruttadauria by Dominic Visconsi, Sr. and James Stanton, the Plaintiff's acquaintances and prominent members of the community. The Plaintiff had no reason to doubt their judgment. In addition, Gruttadauria was not an ordinary broker. He was head and manager of the Cleveland office. It was reasonable for the Plaintiff to rely on the representations of such a senior employee of the Defendants without further investigation. The Defendants position, that one is not justified in relying on the representations of a manager of a major office, is untenable. Accordingly, this element of fraud is satisfied.

The Defendants argue that despite what occurred in 1998 with Gruttadauria, the Plaintiff is still bound by the arbitration provision in the 1996 Options Agreement. McHugh testified that this agreement, relating to the Tissue account, was signed to permit a single options transaction be sought to execute at that time. The arbitration provision, however, broadly encompasses "Any controversy arising out of or relating to any of my accounts". The Court concludes that the arbitration provision in the 1996 Options Agreement does not apply. Whatever obligations it may have imposed initially, this agreement was superceded by Gruttadauria's conduct in 1998. In 1998, the Tissue account was effectively closed and all the assets were transferred to the new Gruttadauria account. The Options Agreement for the defunct Tissue account cannot be used to side step Gruttadauria's later representations.

Finally, the Defendants assert that the Plaintiff's current allegations are beyond the scope of his Complaint. They argue that in the Complaint, he alleges only that Gruttadauria represented that the arbitration provisions were unenforceable, a purported legal opinion. Now, however, the Plaintiff alleges that Gruttadauria promised that the arbitration provisions would not be enforced. The Court concludes that the Complaint must be read broadly enough to encompass the current allegations. Allegations of fraud require only enough specificity to put the defendants on notice as to the nature of the claim. *Arnold v. Arnold Corp.*, 920 F.2d 1269, 1279-80 (6th Cir. 1990). The Plaintiff's assertions meet this test. In addition, Gruttadauria's representations, even if assumed to be a legal opinion, still may be the basis of a fraud claim because Gruttadauria was in the position of a fiduciary. *See Lynch*

*v. Dual Finance Company of Ohio No. 1, Inc.*, 656 N.E.2d 714, 720 (Ohio App. 1995).

## III. CONCLUSION

The Sixth Circuit remanded this case for the Court to consider the Plaintiff's claim of fraud in the inducement of the arbitration clauses themselves, apart from the whole account agreements. The Sixth Circuit, citing *Great Earth* and *Javitch, supra,* instructed that the Court must limit its review to determining whether this dispute is arbitrable, and the evidence must be sufficient for a "reasonable finder of fact to conclude that no valid agreement to arbitrate exists".

Under these standards, the Court concludes that there is no valid agreement to arbitrate due to Gruttadauria's fraudulent misrepresentations. Accordingly, the Defendants' motions to compel arbitration are denied.

IT IS SO ORDERED.

Issued: October 3, 2003

s/ John M. Manos
UNITED STATES DISTRICT JUDGE

ROBERT FAZIO, et al., Plaintiffs, vs. LEHMAN BROTHERS, INC., et al., Defendants. SAMUEL GLAZER, Plaintiff, vs. LEHMAN BROTHERS, INC., et al., Defendants. DOMINIC A. VISCONSI, et al., Plaintiff, vs. LEHMAN BROTHERS, INC., et al., Defendants. PETER A. SPITALIERI, et al., Plaintiff, vs. LEHMAN BROTHERS, INC., et al., Defendants. RICHARD LOPARDO, et al., Plaintiff, vs. LEHMAN BROTHERS, INC., et al., Defendants. THOMAS J. SAVOCA, et al., Plaintiff, vs. LEHMAN BROTHERS, INC., et al., Defendants. PETER M. BONUTTI, Plaintiff, vs. LEHMAN BROTHERS, INC., et al., Defendants.

CASE NO. 1:02CV157, CASE NO. 1:02CV370, CASE NO. 1:02CV382, CASE NO. 1:02CV761, CASE NO. 1:02CV764, CASE NO. 1:02CV968, CASE NO. 1:02CV1018

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF OHIO, EASTERN DIVISION

268 F. Supp. 2d 865; 2002 U.S. Dist. LEXIS 15174

July 19, 2002, Decided

**COUNSEL:** For Robert Fazio, Carl Fazio, Sr., Irene Dugger Fazio, Fazio Investment One Limited, Fazio Investment Three Limited, Plaintiffs (1-02-00157-JMM): Ari H. Jaffe, Byron S. Krantz, Steven R. Malynn, Kohrman, Jackson & Krantz, Cleveland, OH.

For Lehman Brothers, Inc., Lehman Brothers Holdings, Inc., Defendants (1-02-00157-JMM): Douglas V. Bartman, James J. Bartolozzi, Mark R. Jacobs, Kahn, Kleinman, Yanowitz & Arnson, Cleveland, OH.

For Lehman Brothers, Inc., Defendant (1-02-00157-JMM): H. Nicholas Berberian, Neal, Gerber & Eisenberg, Chicago, IL.

For S.G. Cowen Securities, Societe Generale SA, Defendants (1-02-00157-JMM): Christopher M. Ernst, John S. Kluznik, Sr., Mark P. O'Neill, Weston, Hurd, Fallon, Paisley & Howley, Cleveland, OH.

For Hambrecht & Quist, Inc., J.P. Morgan, Defendants (1-02-00157-JMM): Christopher P. Fisher, Elin B. Young, Marvin L. Karp, Michael N. Ungar, Ulmer & Berne, Cleveland, OH.

**JUDGES:** John M. Manos, UNITED STATES DISTRICT JUDGE.

**OPINION BY:** John M. Manos

**OPINION:** MEMORANDUM OF OPINION

In each of these cases, the Defendants have filed motions to compel arbitration and stay proceedings.[1] (*See* Fazio Docket Nos. 38, 48 and 54; Glazer Docket Nos. 26 and 36; Visconsi Docket Nos. 23 and 35; Spitalieri Docket Nos. 11 and 12; Lopardo Docket Nos. 13 and 17; Savoca Docket Nos. 12 and 16; Bonutti Docket No. 13.) The parties have briefed these issues extensively. The arbitration issues overlap sufficiently to permit the Court to issue a single opinion applicable to all these cases.

For the following reasons, the motions to compel arbitration and stay proceedings are DENIED.[2]

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[1] For convenience, the Court will refer to each case by the last name of the first Plaintiff.

[2] Some of these motions also seek dismissal of certain claims pursuant to Fed. R. Civ. P. 12(b)(6). These issues will be addressed in separate opinions.

## I. FACTS

These actions arise out of the conduct of Frank Gruttadauria, who formerly acted as an investment broker for each of the Plaintiffs. He is charged with stealing from the investment accounts he was servicing over a period of approximately fifteen years, and covering up his activity by providing false account statements to the Plaintiffs.

The Plaintiffs have sued the brokerage firms for which Gruttadauria worked over the period of the alleged theft. Generally, the Plaintiffs assert that the brokerages are liable for his conduct. They have brought fraud claims under the federal securities laws, including Section 10(b) of the Securities and Exchange Act of 1934 (15 U.S.C. § 78j(b)) and S.E.C. Rule 10(b)(5), as well as related claims under state law.

Viewing the cases collectively, the brokerage defendants include Lehman Brothers, Inc. and certain affiliated companies (collectively "Lehman"); SG Cowen Securities Corp., its predecessor Cowen & Company, and its parent Societe Generale (collectively "SG Cowen"); and Hambrecht & Quist, Inc., now known as J.P. Morgan Securities, Inc., and its parent J.P. Morgan Chase & Co. (collectively "J.P. Morgan").

The Defendants allege that the Plaintiffs executed various agreements governing their brokerage accounts. These agreements were presented to the Plaintiffs in connection with the accounts to be serviced by Gruttadauria, and allegedly require that all disputes arising out of account activity be resolved through arbitration. The agreement allegedly executed between Plaintiff Robert Fazio and S.G. Cowen's predecessor is representative:

> Any controversy arising out of or relating to any of [Fazio's] accounts, to transactions with [Cowen] for [Fazio's], or to this or any other agreement or the construction, performance or breach thereof, shall be settled by arbitration before an arbitration panel appointed by the NASD or the New York Stock Exchange, Inc. or the American Stock Exchange, Inc. as [Fazio] may elect.

(*See* Motion of SG Cowen, Fazio Docket No. 38, at 3.) Although there may be minor differences among the agreements signed by the various Plaintiffs, they all contain an arbitration provision comparable to that quoted above.

The Defendants assert that the arbitration provisions govern all issues raised in these cases. They, therefore, seek a stay of all court proceedings and an order compelling the Plaintiffs to submit to arbitration. The Plaintiffs essentially argue that the arbitration provisions should not be enforced because Gruttadauria's conduct was far outside the contemplation and foreseeability of the parties at the time the account agreements were executed.

## II. LAW AND ANALYSIS

The Federal Arbitration Act ("FAA") provides in relevant part:

> A written provision in any . . . contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract,

> transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

9 U.S.C. § 2. Once a court determines that issues in litigation are subject to arbitration, the court proceedings must be stayed until the arbitration process is complete. 9 U.S.C. § 3.

Courts have characterized the FAA as expressing a congressional policy favoring enforcement of arbitration provisions. Doubts regarding such provisions should be resolved in favor of arbitration. *Southland Corp. v. Keating*, 465 U.S. 1, 10-13, 79 L. Ed. 2d 1, 104 S. Ct. 852 (1984); *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1, 24-25, 74 L. Ed. 2d 765, 103 S. Ct. 927 (1983) These principles apply to arbitration provisions contained in agreements governing brokerage accounts. *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 480-83, 104 L. Ed. 2d 526, 109 S. Ct. 1917 (1989); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 226, 96 L. Ed. 2d 185, 107 S. Ct. 2332 (1987); *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 219-21, 84 L. Ed. 2d 158, 105 S. Ct. 1238 (1985); *Stout v. J.D. Byrider*, 228 F.3d 709, 714 (6th Cir. 2000), cert. denied, 531 U.S. 1148, 121 S. Ct. 1088, 148 L. Ed. 2d 963 (2001); *Ferro Corp. v. Garrison Industries, Inc.*, 142 F.3d 926, 932 (6th Cir. 1998).

Enforcement of an arbitration clause, however, has limits. First, the dispute at issue must be within the scope of the arbitration provision. *Stout*, 228 F.3d at 714. A party cannot be forced to arbitrate issues for which there was not an agreement to do so, and the parties intentions control. *Sandvik AB v. Advent International Corp.*, 220

F.3d 99, 105 (3d Cir. 2000); *Leadertex, Inc. v. Morganton Dyeing & Finishing Corp.*, 67 F.3d 20, 27 (2d Cir. 1995); *Three Valleys Municipal Water District v. E.F. Hutton & Company, Inc.*, 925 F.2d 1136 (9th Cir. 1991); *Roney & Co. v. Kassab*, 981 F.2d 894, 897 (6th Cir. 1992). In addition, an arbitration provision will not be enforced if it resulted from conduct that would provide for revocation of the contract. *McMahon*, 482 U.S. at 226; *Ferro*, 142 F.3d at 932.

In support of arbitration, the Defendants rely on a body of cases beginning with *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*, 388 U.S. 395, 18 L. Ed. 2d 1270, 87 S. Ct. 1801 (1967). Prima Paint dealt with a situation in which the party opposing arbitration alleged fraudulent inducement to enter the contract. The Supreme Court held that if the alleged fraud pertains to the contract *as a whole*, then the issue of fraudulent inducement must be decided as part of the arbitration process. On the other hand, a fraud claim should be decided by the court if the alleged fraudulent inducement is directed at the agreement to arbitrate *specifically*. In essence, the alleged agreement to arbitrate is effectively considered a separate agreement which may be valid despite being contained in an otherwise fraudulently induced contract. *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*, 388 U.S. 395, 403-04, 18 L. Ed. 2d 1270, 87 S. Ct. 1801 (1967); *see also Burden v. Check Into Cash of Kentucky, LLC*, 267 F.3d 483, 488 (6th Cir. 2001), *cert. denied*, 152 L. Ed. 2d 380, 122 S. Ct. 1436 (2002); *Ferro*, 142 F.3d at 931, 933.

As shown in the cases cited by the parties, *Prima Paint* has been applied generally to challenges based upon the making of the contract. The analysis proceeds upon the following principles. First, there must be a valid and

enforceable contract which includes an obligation to arbitrate disputes. Second, the scope of the arbitration obligation must include the dispute at issue. Third, if the claim is for fraudulent inducement to enter the agreement as a whole, then the disputed issues must be decided by arbitration. If, however, the claim is for fraudulent inducement of the agreement to arbitrate, then the disputed issues are for the Court to decide because the alleged fraud goes to the very legitimacy of the arbitration procedure.

The Court concludes that the Defendants have misapplied *Prima Paint* and its progeny. Those cases apply only to situations in which a party seeks to avoid or rescind an existing contract. It does not apply to challenges to the very existence of the contract on the ground that there was never an agreement at all. *Three Valleys*, 925 F.2d at 1140-41 (whether a contract's signatory had authority to bind a party is a question for the court); *Sandvik*, 220 F.3d at 106 (court must decide whether the underlying agreement containing the arbitration clause exists). An arbitration obligation cannot arise out of a broader contract if the broader contract never existed. *Burden*, 267 F.3d at 488. To avoid arbitration based on the ground that a contract never actually existed, the substance of any alleged misrepresentation must go to its character or essential terms. *Id.* at 490, citing, Restatement (Second) of Contracts § 163 cmt. a (1979).

Here, assuming the Plaintiffs executed the account agreements, they did so with the understanding and expectation that Gruttadauria would act as their broker. He allegedly, however, never had any intention to do so, but rather only intended to steal their money. Because the intentions of the parties differed drastically, there was

never any meeting of the minds, both as to the contract as a whole, *and as to the arbitration clause specifically*. Thus, an enforceable contract never existed. In *Prima Paint*, the alleged fraud centered around the circumstances under which the contract was executed. In contrast, in the current cases the alleged fraud goes beyond just the execution of the account agreements, but goes to the very nature of the relationship. Under the Plaintiffs' allegations, there never really was a broker/investor relationship, so the account agreements are entirely void *ab initio*, including the arbitration provisions.

In this vein, several of the Plaintiffs note that the arbitration provisions relate only to "accounts". They argue that those provisions do not apply because there never were any "accounts" as that term is understood in the brokerage industry. The Court agrees. The plain meaning of "account" in this context is essentially a pool of assets either invested or maintained by the brokerage in cash accounts. Here, the Plaintiffs' assets for the most part were neither invested nor maintained as cash, but stolen. Accordingly, there effectively were no accounts, and the alleged agreements are therefore unenforceable against the Plaintiffs.[3]

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[3] The Court recognizes that many of the Plaintiffs make additional arguments as to why particular account agreements are invalid. Such arguments include, for example, that certain account agreements were never signed, that signatures were actually forged, and/or that the agreements pertain to accounts or transaction categories not at issue. If demonstrated, these arguments would provide additional bases for concluding that the arbitration provisions are invalid and unenforceable. Because the general principles governing contracts and arbitration clauses render the provisions at issue ineffective, the Court need not address each and every specific argument raised by the Plaintiffs.

Even assuming the existence of valid account agreements, *Prima Paint* and its progeny still do not apply because such cases only apply upon the threshold finding that the disputes at issue fall within the scope of the arbitration provisions. Even absent any contractual defects, parties cannot be compelled to arbitrate disputes outside the scope of an arbitration provision. If the Court concludes that claims based upon outright theft are not encompassed by the arbitration provisions here, then the analysis set forth in *Prima Paint* never arises as an issue.

Generally, the underlying basis for the Plaintiffs' claims is Gruttadauria's alleged theft of their assets. They argue that despite the breadth of the arbitration provisions, claims based upon the outright theft of assets are outside the scope. They rely heavily on an unreported Ohio appellate decision, *Cohen v. PaineWebber, Inc.*, 2002 Ohio 196, 2002 Ohio App. LEXIS 161, 2002 WL 63578 (Hamilton Cty. App. January 18, 2002). Like here, the plaintiff in Cohen sued a brokerage firm based upon allegations that a broker had stolen assets from a brokerage account. The account agreement required arbitration of "any and all controversies" relating to the account. The court held that claims based on theft were not within the scope of the arbitration clause:

> Although the arbitration provision is broad, stating that it covers any and all controversies pertaining to the brokerage account, we cannot say, as a matter of law, that a claim alleging such tortious conduct as the aiding and abetting of a theft is subject to the arbitration provision here. An arbitration clause itself is a contract. A contract requires a meeting of the minds as to the terms contained within. At the time that the parties entered into the contract, there was no meeting of

> the minds that the arbitration provision would cover claims alleging tortious forms of theft. If the parties had contemplated, at the time that they entered into the arbitration agreement, that PaineWebber would possibly steal from Ginsburg, that would surely be against public policy. Matters more likely to have been contemplated by both parties would have involved questions of whether a particular transaction was authorized or whether there was any miscalculation in the sum of money contained in the account. Here, the claims filed by Cohen alleged that PaineWebber and Wilhelm had engaged in conduct beyond the scope of the brokerage agreement. Zenni, allegedly with the knowledge of PaineWebber and Wilhelm, had sent altered and false monthly account statements to Ginsburg. Accordingly, under the stated circumstances in this case, we hold that, as a matter of law, the claims of unlawful conversion and fraudulent concealment, were not subject to the arbitration provision.

*Id.* at *3. Although Cohen, an unreported Ohio appellate decision, is not binding, this Court concurs with its reasoning. Conduct amounting to theft is so beyond what is expected from a broker that such conduct could not have been within the reasonable contemplation of the Plaintiffs when they signed the alleged account agreements.

Recognizing that Cohen is not binding, the Defendants argue that the decision should be disregarded because it goes against the weight of long-standing case law favoring arbitration. The Court disagrees with the Defendants' characterization of Cohen as an aberration. The Plaintiffs assert tort claims such as fraud, conversion, theft, and breach of fiduciary duty. Cohen is the only case cited by the parties in which tort claims were brought

based upon broker theft. In other contexts, however, Courts have considered the broader issue of whether tortious conduct is within the scope of broad, contractual arbitration clauses. Thus, Cohen is not an aberration, but merely constitutes one example of the broader issue of applying contractual arbitration clauses to tort claims.

Tort claims are subject to a contractual arbitration provision if based on factual allegations that fall within the scope of the provision. *Fyrnetics (Hong Kong) Limited v. Quantum Group, Inc.*, 293 F.3d 1023, 2002 WL 1312989 at *6 (7th Cir. 2002) (designated for publication); *Gregory v. Electro-Mechanical Corp.*, 83 F.3d 382, 384 (11th Cir. 1996); *Carib Aviation and Marine Consultants, Ltd. v. Mitsubishi Aircraft International, Inc.*, 640 F. Supp. 582, 588 (S.D. Fla. 1986). Tort claims are outside the scope of the arbitration provision if they can be asserted independently without reference to the contract. *Ford v. Nylcare Health Plans of Gulf Coast, Inc.*, 141 F.3d 243, 250 (5th Cir. 1998) (applying comparable Texas law). Applying these principles, courts in many cases have determined that tort claims are outside the scope of arbitration clauses of breadth comparable to that at issue here.

For example, in *Telecom Italia, SPA v. Wholesale Telecom Corp.*, 248 F.3d 1109 (11th Cir. 2001), the defendant brought a third party complaint against an entity from which it leased telecommunications circuits. The lease agreement called for arbitration of "any dispute arising out of or relating to this service agreement". The defendant alleged that the third party tortiously interfered and conspired to undermine its relationship with the plaintiff. The court (quoting a commentator) stated that "parties to an arbitration agreement should be compelled to arbitrate only those torts contemplated by the arbitration

agreement." *Id.* at 1114. In determining whether the tort claims were subject to arbitration, the court considered whether the claims were the "immediate, foreseeable result of the performance of contractual duties". There, the tort claims were not arbitratable [sic] because the third party's conduct extended far beyond the reasonable expectations of the contracting parties. *Id.* at 1116-17 (emphasis added).

In *Ford, supra*, a physician entered into a medical services contract with an HMO. The contract had a provision requiring arbitration of all disputes "arising out of or relating to" the agreement. Dissatisfied with the way the HMO was advertising medical services, the physician brought suit for false advertising under the Lanham Act. The court concluded that, although the terms and polices set forth in the medical services contract were relevant, the competitive injuries alleged under the false advertising claims rendered such claims outside the scope of arbitration. The false advertising claims were wholly independent from the existence of the contract. *Ford*, 141 F.3d at 252.

Similarly, in *Leadertex, Inc. v. Morganton Dyeing & Finishing Corp.*, 67 F.3d 20 (2d Cir. 1995), the parties executed a contract for the purchase of goods. In addition to claims arising from allegations of non-payment, the plaintiff brought a defamation claim asserting that the defendant made defamatory comments about the quality of the plaintiff's products to one of its customers. The underlying contract contained a broad arbitration provision applicable to "any controversy or claim arising under or in relation to this order or contract". The issue was whether the defamation claim was within the scope of the arbitration clause. The court recognized that resolution of

the defamation claim would necessitate examining evidence relevant to the contract claims. The court concluded, however, that the defamation claim was not subject to arbitration because such a claim was beyond the parties reasonable expectations, and never contemplated, at the time the contract was executed. *Id.* at 28-29.

In *Sutton v. Hollywood Entertainment Corp.*, 181 F. Supp. 2d 504 (D. Md. 2002), the parties executed an agreement by which the plaintiff could rent movie videos from the defendant's store. There was an arbitration clause applicable to "any dispute arising out of or relating in any way to Applicant's relationship with HOLLYWOOD VIDEO". On March 1, 2001, an employee of the defendant incorrectly identified the plaintiff as the man who robbed the store the previous evening. The plaintiff was arrested and detained, but later was exonerated after a review of the store surveillance video revealed that he was not the perpetrator. He brought suit for false imprisonment, malicious prosecution, and negligence. The court reasoned that the "relationship" referenced in the agreement meant the "relationship as a video renter". The court concluded that it was "logically untenable" that the video membership agreement was contemplated to cover claims arising out of accusations of theft. The claims, therefore, were not subject to arbitration. *Id.* at 510- 12.

Finally, in *Hersman, Inc. v. Fleming Companies, Inc.*, 19 F. Supp. 2d 1282 (M.D. Ala. 1998), *aff'd,* 180 F.3d 271 (11th Cir. 1999), the plaintiff hired the defendant to oversee the development of a shopping center. As part of the project, they selected an architect and the parties executed an architectural agreement. It required that all "claims, disputes, or other matters in question . . . arising out of or relating to this Agreement" be submitted to

arbitration. Ultimately, the plaintiff brought suit asserting negligence and fraud in connection with the defendant's oversight of the project. The court concluded that the tort claims were not subject to arbitration because the plaintiff's allegations were independent of the obligations imposed by the architectural agreement. 19 F. Supp. 2d at 1286-87.

These cases stand for the general proposition that tort claims are not subject even to a broad arbitration clause if the conduct at issue was beyond any reasonable foreseeability or contemplation at the time the contract was executed. Under these principles, Cohen was decided correctly and applies to this case.

Except for Cohen, the cases cited by the Defendants demonstrate the types of improper conduct that are reasonably foreseeable in a brokerage relationship. The cases involve such conduct as unauthorized trades, executing risky or poor investments inconsistent with an investor's stated investment objectives, generally failing to follow instructions, and "churning" (excessive trading for the purpose of artificially increasing commissions). What these activities have in common is that they stem from trading activity generally within the scope of employment of a broker. When an investor opens an account, it is at least reasonably foreseeable that disputes may arise concerning the propriety of certain trading activity. Such conduct can be subjected to arbitration regardless of how the claims are legally fashioned, be they, for example, framed as common law fraud, breach of fiduciary duty, statutory securities fraud, or even R.I.C.O.

On the other hand, an investor does not open a brokerage account contemplating the possibility that the

assets might be stolen outright. The Plaintiffs' claims are outside the scope of the arbitration provisions because they arise out of alleged activity far beyond any conduct reasonably foreseeable or contemplated from a brokerage relationship. In addition, such claims are independent of any account agreements because they could be asserted even if there had never been any written account agreements.

## III. CONCLUSION

Stated plainly, when the Plaintiffs signed the alleged account agreements, they had no reasonable concern or contemplation that their assets would be stolen. There was, therefore, never any meeting of the minds with respect to any portion of the alleged account agreements, including the arbitration provisions. In addition, claims arising from allegations of outright theft are beyond the scope of such arbitration provisions. Accordingly, the Defendants' motions to compel arbitration and stay proceedings are DENIED.

IT IS SO ORDERED.

Issued: July 19, 2002

s/ John M. Manos
UNITED STATES DISTRICT JUDGE

## ORDER

Pursuant to the Memorandum of Opinion issued in the above-captioned cases this date, the Plaintiffs' claims are not subject to the arbitration provisions contained in the account agreements at issue. Accordingly, the Defendants' motions to compel arbitration and stay proceedings

are DENIED. (*See* Fazio Docket Nos. 38, 48 and 54; Glazer Docket Nos. 26 and 36; Visconsi Docket Nos. 23 and 35; Spitalieri Docket Nos. 11 and 12; Lopardo Docket Nos. 13 and 17; Savoca Docket Nos. 12 and 16; Bonutti Docket No. 13.)

IT IS SO ORDERED.

Issued: July 19, 2002

s/ John M. Manos
UNITED STATES DISTRICT JUDGE

**STATE OF OHIO )**
**) SS: AFFIDAVIT OF**
**COUNTY OF ) FRANK GRUTTADAURIA**
**CUYAHOGA )**

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I, Frank Gruttadauria, being first duly sworn depose and state that I have personal knowledge of the following facts:

1. I am a resident of Cleveland, Ohio, currently in federal custody awaiting sentencing.

2. In 1998, I was a broker and Managing Director of Cowen & Company and also Cleveland Office Manager, and some time in late spring or early summer Cowen & Company was acquired by Societe Generale and was renamed SG Cowen and I held those same positions for SG Cowen.

3. I first met Sam Glazer in late spring or early summer of 1998.

4. When I met Sam, I had been engaged in significant criminal activity against many of my clients for over 12 years and that criminal activity included (among other things) illegally converting client funds out of their investment accounts without authorization.

5. When I met Sam my situation was desperate, both emotionally and financially, primarily because of deep personal remorse and depression as well as customers beginning to make major financial withdrawals from their fictional profits which I had created through the use of fraudulent monthly statements.

6. At that time, almost all of my customers' funds were running low and I deeply needed to raise "new money" in order to satisfy withdrawal demands.

7. In one of my early discussions with Sam Glazer, Sam informed me that he would not open an account with me if he was required to sign our standard customer account agreement because he would not accept arbitration in the event of a legal dispute. I assured Sam Glazer that my title as Managing Director of SG Cowen was sufficient to assure him that SG Cowen would not enforce arbitration against him, and based upon my assurance he agreed to sign the customer agreement and all of our other documents (including a customer agreement covering his earlier Cowen/SG Cowen account with David Tissue).

8. When I said all of this to Sam Glazer I knew it was not true.

9. Within days after Sam Glazer opened his account with me, I started taking money out of his account.

10. While incarcerated, in a recent interview with senior lawyers with SG Cowen, I told them about my assurance on arbitration to Sam Glazer.

FURTHER AFFIANT SAYETH NAUGHT.

/s/ Frank Gruttadauria
Frank Gruttadauria

Subscribed and sworn to before me this 29th day of October, 2002.

/s/ Suellen Oswald
Notary Public

Suellen Oswald,
Notary Public
State of Ohio
No Expiration Date

Gruttadauria, Frank D.

---

Dear Sir:

I was a Managing Director with Lehman Brothers in Cleveland, Ohio from October 16, 2000 through to January 11, 2002.

During the course of the past 15 years I have caused misappropriation through various methods which resulted in other violations. It has occurred at Lehman Brothers, SG Cowen Securities Corp, Cowan & Co., Hambrecht & Quist, Inc, and LF Rothschild Inc. I did not take monies for my personal use and I was the sole knowing participant.

It is a complicated and substantial interwoven fabric of digressions, most of which will be evident in the digital tapes that I have put in the credenza of the conference room in the Lehman Brothers office in Cleveland for you.

Management at Lehman Brothers and any of my former employers or customers are unaware of the activities.

This began as an attempt to make up lost monies for customers and mushroomed over the course of time I suppose I was emboldened with the process continuing and I can hardly believe that I could have done this without detection for so long, the various firms greed and lack of attention at the senior level contributed greatly to that. Be that as it may, I am unwilling to continue and am ashamed and sorry for what I have done.

I don't have the strength presently to face this but wanted to get this into your hands so that it will stop.

Frank Gruttadauria

Lehman Brothers Inc. – aquired SG Cowen
Private Client Group 10/16/2000
399 Park Ave
New York, NY 10022

SG Cowen Securities Corp
1221 Avenue of the Americas
New York, NY 10021

Cowen & Co-aquired by Societe Generale 7/1/1998

Hambrecht & Quist Inc. – aquired by Chase Manhattan Bank 1999

LP Rothschild Inc – aquired by Franklin S&L and recieved by RTC 1989

*The Wall Street Journal March 17, 2005 Thursday*

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**THE WALL STREET JOURNAL.**

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**HEADLINE:** Rough Justice: Wall Street Panels For Settling Fights Draw Renewed Fire – 'Public' Arbitrators May Have Had Ties to Brokerages; NASD Considers a Change – The Smiths Lose $67,000

**BYLINE:** By Susanne Craig

**BODY:**

When investor Bruce Gimelson thought the brokerage TD Waterhouse had cheated him out of $70,883 by selling shares in his account without permission, he was forced to turn to Wall Street's homegrown justice system to try to get the money back.

He filed a securities arbitration claim with the New York Stock Exchange, which promises that two of the three members of its arbitration panel will come from the general public, not the securities industry. But Mr. Gimelson's lawyer was surprised when he found out that one of the "public" arbitrators on the panel was Laurie Zeligson, who worked as a lawyer at Citibank for a dozen years through 1998 and later represented the bank and a securities firm

in private practice. The panel ruled against Mr. Gimelson, while denying Waterhouse's attempt to collect the $15,351 it said he owed.

Last year, Ms. Zeligson went to work for a Prudential Financial Inc. money-management unit but continued serving as a public arbitrator on a case that was already in motion, voting in favor of a securities firm in an NYSE employment-arbitration dispute. During her arbitration career, she voted in favor of Wall Street firms in all seven customer and employee cases she heard.

Ms. Zeligson said in a brief interview that she is no longer serving as an arbitrator. She later said in an e-mail that she believes she "brought the expertise necessary to serve as a public arbitrator." While the NYSE says Ms. Zeligson was properly classified as public when she heard Mr. Gimelson's case in 2000, it now says it should have reclassified Ms. Zeligson when she moved to Prudential, "We should have asked for more information," says NYSE arbitration chief Karen Kupersmith. "Conflicts are important to us."

Investors have been complaining for years that the arbitration system is stacked in favor of Wall Street. But the debate has intensified in recent years amid a swell of new arbitration claims following the burst of the Internet bubble in 2000. Now, some members of Congress and state officials are starting to turn up the heat on the industry. And the self-regulatory bodies that run the arbitration forum have started tinkering with the system to make it appear more fair.

"Combine a public arbitrator who has a long association with Wall Street with an industry arbitrator who works on Wall Street and the investor is not being served," says

William Galvin, the top securities regulator in Massachusetts. A subcommittee under the House Committee on Financial Services will hold public hearings on securities arbitration today.

Investors' claims are heard either by panels at the NYSE or the National Association of Securities Dealers. The NASD handles roughly 90% of arbitration cases.

After receiving questions from The Wall Street Journal, the NASD recently said it is considering a rule change that would bar people such as Ms. Zeligson from serving as a public arbitrator. The new rule would remove people who work for firms that own or are owned by a NASD-registered firm such as Prudential from the public-arbitrator list.

The securities industry's brand of justice took off after a Supreme Court ruling in 1987 allowed brokers to require customers to waive their right to sue in court as a condition of opening a brokerage account. Today such clauses are standard, which is why investors' complaints usually end up in arbitration.

It has long been debated whether the securities industry should be permitted to police itself through an arbitration process that it controls. Wall Street has responded by requiring that two of the three arbitrators represent the public, which officials say helps ensure the system's fairness. The third arbitrator must come from Wall Street, an effort to ensure knowledge of the inner workings of the brokerage industry. Big brokerage firms often encourage their employees to sign up as arbitrators.

In practice, though, even some "public" arbitrators have ties to Wall Street. Even if an arbitrator previously worked

as a Wall Street broker, the NASD classifies the person as public if he or she held the brokerage job for fewer than 20 years and has been out of the business for at least five years. The NASD also counts accountants and lawyers as public if they get less than 10% of their income from brokerage clients. The NYSE has its own rules, including some similar to the NASD's that leave the door open for former Wall Streeters to be classified as public.

Officials who run the arbitration system say it is fair and in recent years have even toughened the rules. For instance, the NASD last year changed its rules to force Wall Street insiders to wait five years instead of three before they can sit as public arbitrators. Linda Fienberg, the NASD's head of arbitration, says a five-year break from the financial business is sufficient for an arbitrator to be classified as public. "That person will be knowledgeable and yet will be able to understand when firms engage in misconduct, and is as likely to find in favor of investors as someone who has no connection," she says.

In 2004, 8,201 cases were filed with the NASD, a 47% jump from a decade earlier. Most involved aggrieved investors, although arbitration panels also hear complaints from brokerage employees against their employer and sometimes from one brokerage against another. In 2004, arbitrators ruled for investors 55% of the time, the NASD says. But an analysis by the Journal of about 1,000 cases ruled upon by around 40 of the country's most-active arbitrators shows that arbitrators return a much smaller fraction of the total damages claimed by investors. The NASD doesn't supply data on the size of damage awards relative to the amount sought.

Arbitrators, who typically make $400 a day, aren't required to justify their decisions. That could change, though: The NASD's board recently discussed requiring arbitration panels to provide a written decision if the complainant requests it in advance. The rule would require approval by the Securities and Exchange Commission.

Jonathan and Mary Ann Smith took J.W. Genesis Financial Services Inc. to arbitration in 2000 after they lost nearly $67,000 investing in three small stocks. Two of the companies had warned in regulatory filings that their stock was only suited to those who could afford losing their entire investment, but the Smiths said their broker hadn't told them this.

One of the arbitrators in the case was Patricia Bottoms, a former broker at Prudential Financial's Prudential Securities unit as well as Lehman Brothers Holdings Inc. between 1984 and 1990. For years, Ms. Bottoms was classified as an industry arbitrator but she became a public arbitrator five years after leaving Wall Street, in accordance with NASD rules. The panel ruled unanimously against the Smiths.

"I don't think someone who has spent years working on Wall Street should be standing as a public arbitrator," says Mr. Smith, 50 years old, who installs computers for a living. "It has to prejudice them."

Ms. Bottoms disagrees, "There is absolutely no benefit to the arbitrator to go about their business with that *type* of prejudice," she says. She has served on five securities-arbitration panels involving employees or customers. She has voted in favor of Wall Street firms four times.

At both the NYSE and the NASD, the two parties in arbitrations have limited rights to strike arbitrators from a panel. At the NYSE, there are three methods of choosing a panel but the majority of panels are named by the exchange and lawyers get one automatic exclusion. After that, they're stuck with the panel they get unless they can demonstrate a conflict. In the case of Mr. Gimelson, the investor who had a complaint against TD Waterhouse, his lawyer, Steven Caruso, was left with Ms. Zeligson because he used his exclusion to strike another arbitrator.

At the NASD, lawyers are presented with a list of 15 potential arbitrators and allowed to strike as many as they wish. But if the two sides strike so many people that there aren't three left for the panel, the NASD returns to its database and picks a new panel of three by appointing the next available arbitrators that come up in the rotation. Neither side can exclude any of them. Lawyers can still appeal to the NASD to remove an arbitrator "for cause" but they must demonstrate a potential bias on the part of the arbitrator.

"I have been stuck with Ms. Bottoms twice with no say whatsoever in the matter," says John J. Miller, a lawyer in Kansas City, Mo., who represented the Smiths.

Some arbitrators with finance experience say it's misleading to portray them as "Wall Street insiders." Among them is James R. Greene, a former president of American Express Bank and of the Bankers Association for Finance and Trade, who is classified as a NYSE public arbitrator. He is now retired, but serves as a director at Israel's Bank Leumi.

"Wall Street, as I use the phrase, is somebody in the brokerage business," Mr. Greene says, "I lent money to

people and collected it back. I was not a trader and did not have responsibilities for traders."

In a rare challenge to the system, Tom Ajamie, a plaintiffs' lawyer in Texas, filed a lawsuit against the NYSE in April 2004 in a bid to have arbitrator Robin Henry removed from a panel hearing his client's $23 million claim against Prudential Financial.

Ms. Henry has long ties with Wall Street, Mr. Ajamie contends. She worked at Merrill Lynch in the early 1980s and now is chairwoman of a charity that receives donations from Wall Street firms including Citigroup and J.P. Morgan Chase.

In the suit, filed in New York state court, Mr. Ajamie says Ms. Henry fell asleep during hearings. At a court hearing related to the Ajamie case, Matthew Farley, a lawyer representing Prudential, said Ms. Henry closes her eyes from time to time but "I don't believe she is sleeping." The suit also says Ms. Henry has coached Wall Street witnesses by shaking her head to indicate which way they should answer.

The 75-year-old Ms. Henry doesn't disclose her charity's connections in the resume she provides to the NYSE. An active arbitrator, she has ruled in favor of Wall Street firms about half the time, in line with the industry average.

In June, a judge rejected Mr. Ajamie's request to have Ms. Henry removed from his client's panel. The judge ruled that Mr. Ajamie failed to show a specific relationship between Ms. Henry and Prudential that would present a conflict.

Reached by phone, Ms. Henry referred questions to the NYSE. A spokesman for the exchange said that despite the allegations against Ms. Henry, "the court has found no evidence of impropriety or any disqualifying relationship." He declined to comment on Mr. Ajamie's specific allegations.

Charles Braisted worked for 30 years at law firm Davis Polk & Wardwell, which represents many top Wall Street firms, before setting up a private practice. He has since represented several Wall Street clients including Morgan Stanley and Prudential Securities. Nonetheless, the NASD recently reclassified him as a public arbitrator because of the five-year rule.

Mr. Braisted says he was slightly taken aback when he received the reclassification notice. But he thinks of himself as independent of Wall Street because most of his legal work in recent years has involved corporations, not brokerages. "I get upset when I see instances when a broker has ripped off a client or where a brokerage has not performed its compliance duties," he says. Mr. Braisted has ruled for investors in each of the three arbitration cases he has heard involving client complaints.